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EXAMINING THE IMPACT OF THE PROPOSED RULES TO IMPLEMENT BASEL III CAPITAL STANDARDS

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT

AND THE

SUBCOMMITTEE ON
INSURANCE, HOUSING AND
COMMUNITY OPPORTUNITY

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

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EXAMINING THE IMPACT OF THE PROPOSED RULES TO IMPLEMENT BASEL III CAPITAL STANDARDS

Thursday, November 29, 2012

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT, AND
SUBCOMMITTEE ON INSURANCE, HOUSING
AND COMMUNITY OPPORTUNITY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittees met, pursuant to notice, at 10:03 a.m., in room 2128, Rayburn House Office Building, Hon. Shelley Moore Capito [chairwoman of the Subcommittee on Financial Institutions and Consumer Credit] presiding.

Members present from the Subcommittee on Financial Institutions and Consumer Credit: Representatives Capito, Renacci, Hensarling, McHenry, Pearce, Westmoreland, Luetkemeyer, Huizenga, Duffy, Canseco, Fincher; Maloney, Gutierrez, Watt, McCarthy of New York, Lynch, Miller of North Carolina, and Scott.

Members present from the Subcommittee on Insurance, Housing and Community Opportunity: Representatives Biggert, Hurt, Miller of California, Garrett, Westmoreland, Duffy, Dold, Stivers; Gutierrez, Waters, Watt, Sherman, Capuano, and Cleaver.

Also present: Representatives Hayworth; Green and Perlmutter.

Chairwoman CAPITO. I would like to call the hearing to order.

I first would like to say that Mrs. Maloney, who is my ranking member—there is a lot going on in the Democrat caucus right now. I am sure they will be here shortly. So they said to go ahead and start, and we have Mr. Scott here to carry the flag. So I am going to go ahead and call the hearing to order.

I would like to thank Chairwoman Biggert, Ranking Member Maloney, and Ranking Member Gutierrez for their cooperation in holding this joint hearing on capital requirements for financial institutions.

We have two panels with very diverse witnesses, and they will be presenting various concerns about the proposed rule to implement the Basel III capital requirements. Because this is a joint hearing with two large witness panels, I would ask my fellow colleagues, if they would—I am going to gavel us down at 5 minutes on questioning because we have a lot of interests and we have a large panel at the same time.

Before I begin my formal opening statement, I would like to take a minute to thank my good friend, Chairwoman Judy Biggert from Illinois. This will probably be her final hearing. She has been a mentor to me, and a good friend. She has been wonderful, had wonderful service on this committee. She understands the issues very deeply, and she cares. And I think all of you who have dealt with Judy through the years are going to miss her as much as I am, and this committee will miss her.

So, Judy, I want to say thank you. Thank you for getting the flood bill through.

I tease her about being "Miss Flood," but she got it through. And it was her perseverance and her dedication to that issue that actually saw it all the way through to the President's desk. So if we could give Judy a little round of applause.

[applause]

Chairwoman BIGGERT. We will never get to the hearing.

Chairwoman CAPITO. Judy said, "We will never get to the hearing." She is always working.

In early June of this year, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the FDIC jointly proposed three rules to revise risk-based capital requirements to make them consistent with the Basel III Accords.

Like many of my colleagues—and it is really surprising to me how vocal the concern has been—I have heard a lot of concern from financial institutions of all sizes about the effect that implementation of these capital requirements will have on the health of financial institutions, their ability to lend, and the subsequent effect on the economy.

Although there was near-unanimous expectation that these capital requirements would only apply to the largest banks, many were surprised when the U.S. Federal agencies applied standards that were designed for large complex institutions to regional community banks, as well.

Higher capital requirements for large complex institutions are entirely appropriate. Over the last year, we have seen firsthand that a well-capitalized financial institution can sustain a significant loss because they are holding sufficient capital. Furthermore, higher capital requirements may help prevent our Nation's largest financial institutions from becoming even more systemic. The Basel III Accords were designed to address many of the issues posed by large, complex, systemic financial institutions. It is less clear whether these specific capital requirements are appropriate for regional and community banks.

The United States is very fortunate to be served by a highly diverse financial system. The diversity in our system is evident in the different banks that are testifying here today. Pendleton Community Bank, near and dear to my heart, from West Virginia is a $260 million asset bank located in rural West Virginia. Fifth Third Bancorp is a $117 billion regional bank serving 12 States. And Citigroup is a nearly $2 trillion bank serving clients across the globe.

These institutions have unique business models designed to serve different types of customers. The one-size-fits-all approach to regulatory capital in the proposed rules does not take into consideration

the diversity of our Nation's financial system and the unique challenges faced by different size institutions.

Furthermore, as we will learn from several witnesses today, the proposed rules will apply to insurance companies that own their own thrifts. Again, there needs to be significant flexibility in the way these rules are finalized that properly takes into account the differences in their business models.

I know that the regulatory agencies are currently reviewing thousands of comments on the proposed rules, and I thank them for their diligence in reviewing the comments.

We can all agree that higher capital requirements are an important tool in ensuring that we have a safe and sound financial system. However, it is my hope that today's hearing will demonstrate to the regulatory agencies the importance of appropriately tailoring these requirements to the different size financial institutions in the United States.

So that is my opening statement. I now recognize Mr. Sherman for an opening statement.

Mr. SHERMAN. Thank you.

Increasingly, we find in this committee that what the regulators do is more important than what we do. That is in part because Congress finds it so difficult to pass a statute. It is an old saying in the English language, the American language, "It takes an act of Congress."

Still, we are a democracy. And if regulators are going to pen the important laws, they should be listening to the elected representatives of the people, even if those representatives can't come together to the point of drafting statutes that are binding on them.

I think that there will be a general consensus here that while certain basic principles would apply to all banks and relevant insurance companies, we need to have substantial differences in the ultimate principles as they apply to those that are the largest and the smallest, and perhaps some other differentiations, as well.

With that, I yield back.

Chairwoman CAPITO. The gentleman yields back.

I recognize Mrs. Biggert for 2 minutes for an opening statement.

Chairwoman BIGGERT. Thank you, Madam Chairwoman.

Contributing to the recent collapse of many financial institutions across the country was a flawed regulatory system, ineffective rules, and asleep-at-the-switch regulators. Sufficient capital, sound risk management, and prudent regulation are critical components to ensure the availability and reliability of financial products to consumers and the solvency of financial institutions large and small alike.

Federal bank regulators proposed rules to implement the new Basel Accord, Basel III, increase capital for the sake of increasing capital, while treating insurance like banking; multifaceted large banks, like small banks; and 1-day and 5-day derivatives contracts the same. They don't make much sense. What could be the cost of negligence should these proposed rules not improve? It is not the most sound and effective regulation, and at a time when we can least afford increased costs to families and businesses as well as no or slow job and economic growth. Regulations should first aim to do no harm.

To comply with Basel III, our regulations must strike the right balance. They should be tailored to different and changing business models, account for a wide variety of financial products and inherent risks, and set capital requirements accordingly. The proposed rules don't achieve these goals.

Today, I look forward to a commitment from the Federal Reserve that they, in fact, will improve this rule and not simply commit to review and consider submitted comments.

I thank Chairwoman Capito for her hard work in putting together today's very important hearing, and I thank the witnesses for their participation.

And I yield back.

Chairwoman CAPITO. Thank you.

I would like to recognize Mr. Miller for—do you have an opening statement?

Mr. MILLER OF NORTH CAROLINA. No.

Chairwoman CAPITO. Before I move on to Mr. Scott, I would like to thank Mr. Miller, as well, for his service to this committee and to this Congress. He will be leaving us. As we all know, Mr. Miller is a very dedicated and ardent advocate in his beliefs. And I believe he has enhanced the quality of the committee, and I want to thank him for his service.

Thank you.

[applause]

Chairwoman CAPITO. Even though he is a Carolina fan and I went to Duke, but that is okay.

I would like to recognize Mr. Scott for as much time as he may consume for an opening statement.

Mr. SCOTT. Thank you very much, Madam Chairwoman.

And I, too, want to commend Mr. Miller for his excellent service. We came into the Congress together and went on many trips abroad together, and we are good friends.

I wish you the very best, Mr. Miller.

This is indeed an important hearing, and it is very important to me because I represent Georgia, a State that has led the Nation in bank closures. So I know firsthand some of the difficulties that banks are facing now—not only a struggling economy, overvaluation of real estate portfolios that had an effect, but also these regulations that we are putting in place to prevent such a calamity from happening again. We are trying to propose sufficient regulations in the midst of economic recovery and difficulties for our banks.

So I am very, very concerned about banks. And it is very important for us to note that many banks are still struggling under the pressure of a recovering economy, along with these tighter regulations that are being put in place.

But I am very supportive of efforts to improve capital standards for banks in order to ensure that every banking institution, regardless of size, has a sufficient financial buffer to absorb losses. However, through regulators' efforts to strengthen the banking system by means of new requirements, community banks, especially in my State of Georgia, have suffered from the burden of maintaining unnecessarily high levels of capital, and we need to examine that. What really works best?

Community banks have expressed to me direct concern regarding the proposed Basel III rules on capital requirements and the effect they would have on bank lending and especially on the local economy in my State of Georgia. They maintain that these regulations would require them to increase their capital and liquidity holding on small business loans and mortgages, in turn reducing Georgia consumers' access to these loans.

So this causes me great concern during this time of economic recovery, and especially in Georgia, as well, because we have a high unemployment rate which is above the national average. Our unemployment rate right now is hovering at 9 percent.

I expressed my concerns on this issue just last week in a letter that I wrote to Chairman Bernanke, Comptroller Curry, and Acting Chairman Gruenberg, where I asked for regulators to take appropriate time to adopt rules that distinguish between the systemic risk and megabanks and to study the potential impact that each rule change would have on the banking industry. There is a difference between your big megabanks, your regional banks, and your community banks. One size just does not fit all.

I am also concerned about the overall impact of the Basel III proposals in conjunction with other regulations, such as those mandated by the Dodd-Frank Act and other regulatory and accounting rule standards on credit availability, the cost of credit. This is a monumental issue of great complexity, and we have to make sure that we get it right, that we understand the impact, and that we really don't have too many unnecessary consequences that will result in negative impact on our customers and our consumers, because that is what we are all here to try to solve.

With that, I yield back, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

I recognize Mr. Hurt for 1 minute.

Mr. HURT. I thank the Chair for yielding and I appreciate Chairwoman Biggert and Chairwoman Capito for convening this important hearing today.

I wanted to echo my thanks to Chairwoman Biggert for her service. It has been a privilege to be able to serve on the Insurance and Housing Subcommittee with you, and I thank you for that.

As our committee has heard throughout this Congress, the proposed Basel III capital requirements appear to have been made without regard for their unintended consequences and negative impacts on the economy. While sufficient capital requirements are essential to a strong banking and financial system, they must be appropriately tailored to consider the intricacies of a diverse financial business model rather than a one-size-fits-all system.

Community banks in Virginia's Fifth District, my district, have told me that the proposed rules' complexity will impose significant costs. In light of other regulatory impacts they face from Dodd-Frank, these banks will be hard-pressed to transition to these new capital standards without eliminating key portions of their business that serve our communities.

Additionally, I am concerned by the way that proposed rules treat insurers with depository institution holding companies. The assets, liabilities, and accounting practices of insurers are quite dif-

ferent than those of banks, yet the rules do not differentiate between these entities.

As the regulators promulgate the final rules, I hope they will take these concerns into account so that these capital requirements can accommodate the needs of different enterprises that will be impacted by these regulations and minimize the potential harm to our economy.

I look forward to hearing from our witnesses, and I yield back the balance of my time.

Chairwoman CAPITO. I recognize Mrs. Maloney for an opening statement.

Mrs. MALONEY. First of all, I thank you for calling this incredibly important hearing.

And I want to join my colleagues in applauding Judy Biggert for her outstanding service to our country. During this time when flood relief is so important in New Jersey and New York and Westchester, her work on the flood bill last year, modernizing it, getting it in shape, really, really is being felt in our neighborhoods. And I want to congratulate her on that work.

I also want to mention a bill that we put in that became law and is still law, and that was on Afghan women. The Taliban are prosecuting women. We put in a bill that $60 million of our aid to Afghanistan would go to NGOs either headed by women or helping women, and created a human rights commission where men and women, children, all people could appeal for their rights. It was important legislation.

Judy, I just appreciate all of your hard work in so many ways.

And Brad Miller is such an outstanding member of our caucus and of this committee, authoring and passing many important bills. And I have so such regard for his intellect and his integrity and his judgment that, literally, I tried to hire him as my personal lawyer when he left. He is telling me he is not going to practice law, but he is a brilliant lawyer, and a brilliant member of this committee.

We are going to deeply, deeply miss you.

I congratulate both of them on their outstanding, incredible service to this incredible body, our Congress.

I want to thank everyone here and welcome the witnesses today.

Four years ago, we learned a couple of very important lessons. We learned that banks were undercapitalized, overleveraged, and vulnerable to economic shock. We also learned that some types of capital can protect a financial institution better than others in a crisis. And since that time, Congress, the financial institutions themselves, and the regulators have taken a number of critical steps to ensure that the banking system can withstand the next financial crisis.

Several provisions of the Dodd-Frank Act, including the Collins Amendment, are aimed at strengthening banks' capital and shoring up their Tier 1 capital. And banks are better capitalized now than ever before. Total capital is up by 10 percent since 2009. And the number of unprofitable banking institutions has dropped from 28 percent of the total in 2009 to 11 percent in 2012.

The global regulatory community has also been working to implement Basel III, and the U.S. regulators issued a three-part rule to

do so in June. The rules that were issued in June reflect the recommendations of the Basel Committee and focus on three areas: imposing minimum regulatory capital ratios and buffers; defining rules for risk-weighted assets; and setting the supplementary leverage ratios for large, internationally active banks.

Since the proposed rule was issued, concerns have been raised by a number of entities with respect to how these rules will impact small community banks and regional banks as well as insurance companies that will have to comply with them. I do not support the rule at this time, and I share a number of concerns.

First, I do not believe that smaller community and regional banks should be swept into Basel III and forced into it. If they want to opt in, fine. But Basel is meant for larger, cross-border banks that do business internationally, and not for small community and regional banks that are already well-capitalized. And I repeat, they were not part of the crisis.

They are an important part of the banking system. Even in the great City of New York, where we have many large banks, they serve the community. And to put these compliance costs on them and these regulations, when they are not involved in international business—they are really supplying services to the community. I am concerned that these requirements may force a lot of community and regional banks out of business. So I am very, very concerned.

Second, I am concerned that the proposed risk weights are punitive and will mean the consumers who cannot afford to put down a 20 percent downpayment will be penalized. We need real risk-based criteria and real metrics, not a further restriction of the housing market. And I feel that should be more completely defined.

And, finally, I am concerned about the proposed rules that are overly complex and could prove incredibly costly to implement. Despite their complexity, they do not take into account the various business models of covered entities, specifically insurance companies that will have to comply with them even though they are covered by many other regulations in other areas.

Those who are working on the rule announced a couple of weeks ago that they will not issue a final rule until after the first of the year. I think that is a positive thing. And I am pleased to see that they are taking the time to get it right, to address the concerns from the industry, and to hopefully coordinate with our global partners. But I hope they will be able to shed some light on their timeframe for issuing a final rule.

Between the two panels here today, we have a range of regulatory bodies and industry represented, as well as leaders on these subjects. So I look forward to hearing from them. I feel this is a critically important hearing, and I compliment my colleague for calling it.

Chairwoman CAPITO. Thank you.

Mr. Hensarling for 2 minutes.

Mr. HENSARLING. Thank you, Madam Chairwoman. I appreciate you and Chairwoman Biggert holding this particular hearing.

We have had many debates in this hearing room about the Dodd-Frank Act. I suspect there will be more in the future. And regardless if it is perceived in real benefits, many of us believe that there

has been a substantial cost by the imposition of very complex, expensive, weighty rules upon our financial markets, ultimately making capital more expensive and less available.

Unfortunately, on top of that now comes Basel III, weighing in, I believe, at over 1,000 pages, when I am not so certain we were well-served by either Basel I, Basel II, or Basel II-and-a-half. We know that the regulators decided, in their wisdom, that financial institutions should reserve less against both sovereign debt and agency MBS, and I think we know how that all played out.

I have heard some very encouraging things on both sides of the aisle, particularly Members indicating a concern about one-size-fits-all. I would agree with the ranking minority member that it is a very open question whether Basel III should even apply to our community-based financial institutions. So let's hope the bipartisan concern and support is a harbinger of things to come in the 113th Congress.

Clearly, the case can be made that we need more capital. A case can be made that we need higher quality capital. It is a very poor case for more complex capital standards that do not recognize the difference between large money center banks and our community financial institutions.

Somebody recently sent me a quote from Einstein that I will close with, Madam Chairwoman. The quote is this: "We cannot solve our problems with the same level of thinking that created them." I believe that applies to Basel III.

I yield back.

Chairwoman CAPITO. The gentleman yields back.

Mr. Lynch for 2 minutes.

Mr. LYNCH. Thank you, Madam Chairwoman.

I want to welcome all the witnesses and thank you for coming before this committee and helping us with our work.

One of the important lessons that we learned from the recent financial crisis is that some banks were not required to hold sufficient capital, either because it wasn't enough capital or the capital itself was not of sufficient quality to withstand the significant losses unleashed by the housing bubble bursting.

As a result of the actions by the Basel Committee and the requirement in the Dodd-Frank Act, U.S. banking regulators are moving forward with the rules to modernize our outdated and inadequate minimum capital rules. I have heard a lot of folks here and elsewhere describe these minimum capital rules as complex, but I think that is perhaps a little bit misleading. The idea behind the rules is actually fairly simple and straightforward: the level of capital banks have to hold because of assets on their books should be determined by how risky those assets are.

What has become complex is not this idea but the business of banking itself. And as a result, the rules putting this simple idea into play, that minimum capital levels should reflect risk, have become more convoluted.

No one here today would argue that Basel I rules, which treat a commercial loan to a blue chip company and a commercial loan to an Internet startup as equally risky, are too complex. In fact, nearly everyone concedes that those rules are too simplistic and are outdated in our modern world of financial innovation. We need

rules that reflect the dynamic and sometimes volatile world of modern finance, and those rules also may wind up reflecting modern finance's complexity.

I am sympathetic, I admit, to the community banks. And I would like to hear from some of our witnesses who represent the community banks, particularly the regulators who oversee them, about how we can make these rules easier for the community banks to implement, whether by making some of the more convoluted risk-weighting calculations prospective and providing the community banks with an extended on-ramp time or some other way to ease the burden of community banks.

Again, I thank the witnesses for coming here today, and I look forward to hearing your testimony.

Thank you.

Chairwoman CAPITO. Thank you.

Mr. Miller for 1 minute.

Mr. MILLER OF CALIFORNIA. I would like to thank the chairwoman for hosting this hearing today.

There is no question that robust capital standards, when properly applied, will help protect our economy. But when we proceed with caution, such standards can actually be detrimental to our economy if not properly applied.

Capital standards need to be set appropriately so they can ensure the safety and soundness of financial institutions without harming the availability of credit to fuel economic growth and the ability of small banks to serve their communities.

I am really concerned about the proposed rules' treatment of insurance companies that own depository institutions. The bank-centric approach to the proposed rules is inconsistent with the safe supervision of insurance companies and could actually harm the solvency of the insurance industry, which is actually the opposite of what Congress intended.

Earlier this year, Chairman Bernanke acknowledged before the committee that appropriate capital standard regulations should take into account the different compositions of assets and liabilities of insurance companies. Just yesterday, Senator Collins, the author of the language in the Dodd-Frank Act, sent a letter to the Federal Reserve, the FDIC, and Treasury stating that, "It was not Congress' intent that Federal regulators supplant prudential State-based insurance regulations without bank-centric capital standards."

I ask unanimous consent for that letter to be introduced into the record.

Chairwoman CAPITO. Without objection, it is so ordered.

Mr. MILLER OF CALIFORNIA. I would be concerned that the proposed rules do not take into account the different business models and risk profiles of insurance companies.

I yield back.

Chairwoman CAPITO. Thank you. The gentleman yields back.

Mr. Duffy for 1 minute.

Mr. DUFFY OF WISCONSIN. Thank you, Madam Chairwoman.

For Basel III, I support increasing capital requirements on our larger banks to insulate the American taxpayer from bailing out large financial institutions again. However, I come from rural Wis-

consin, where we are served by a number of small community banks, and I am concerned about the impact Basel III will have on their ability to continue serving our communities.

So today, I hope the panel will discuss a few issues. First, under Dodd-Frank, small bank holding companies were allowed to hold trust-preferred securities as Tier 1 capital. Basel III requires these small banks to phase out their trust-preferred securities, which will create significant problems for them to access capital. Second, address the extra burden placed on small banks from calculating gain or losses on available-for-sale securities rather than continuing to use book value. And third, the rationale used for setting risk-weighting for mortgages.

Thank you, and I yield back.

Chairwoman CAPITO. The gentleman yields back.

I would like to recognize Mr. Dold, but before I do that, I would like to thank him for his service. He did jump ship from the Financial Institutions Subcommittee over to the Capital Markets Subcommittee, but I got over it quickly. He has been a great Member of Congress and a great member of this committee, and we will miss him.

Mr. Dold for 1 minute.

Mr. DOLD. Thank you, Madam Chairwoman. And I certainly appreciate your leadership.

I also wanted to thank my good friend and neighbor in Illinois, Judy Biggert, for her leadership. It is certainly an honor to serve with you, and also my good friend Quico Canseco.

I want to thank our witnesses for being here today. And while my colleagues and I generally support increasing the level of high-quality capital in the banking system, I have some serious concerns about the proposed rules implementing Basel III and their impact on our fragile economy.

First, I am concerned that the overall complexity of the proposed risk-based capital requirements would result in meaningful and unnecessary new compliance costs for domestic banks, particularly our community banks. And we have heard that from a number of folks on both sides of the aisle.

I am also concerned that the specific risk weights are misguided and could raise costs for many consumers, including small-business owners, who want to use equity perhaps even in their homes to invest in their business and create additional jobs.

I do think that is one of the things that we all have to be focusing on: How do we create an environment that enables the private sector to create more jobs with an unemployment rate as high as it is today? We can't have a one-size-fits-all mentality for our banking system and capital requirements.

I yield back.

Chairwoman CAPITO. The gentleman yields back.

I would like to recognize Mr. Canseco for 1 minute, and thank him for his service. Certainly, on my subcommittee, he has been a force of great knowledge. He has great background in banking.

We will miss you, Quico, but I don't think we have heard the last from you. So Godspeed, but also, 1 minute for an opening statement.

Mr. CANSECO. Thank you. Thank you, Madam Chairwoman. And I thank you and Chairwoman Biggert for your leadership in holding this hearing today.

The financial crisis of 2008 exposed two glaring problems with our financial system in existence at that time. First, the financial system was woefully undercapitalized to deal with the buildup of shaky mortgage assets. And, second, the rules governing capital of the largest institutions, known as the Basel regime, were deeply flawed and, in my opinion, exacerbated the crisis. The Basel regime incentivized banks to over-weight mortgages and considered the debt of countries such as Greece and Spain to be bulletproof.

The fact that today we are discussing Basel III reminds us that regulators have been here twice before, but, unfortunately, I don't see much in the proposed rule which fixes the flaws that already exist within the Basel system. Instead, I see another iteration of the belief that greater complexity leads to better regulation.

Sufficient capital is essential to a safe and sound financial system, and I feel today's hearing will be successful if we have a serious conversation about the problems with the Basel regime and look to chart a proper course ahead of the regulation of capital in our financial system.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

Mr. Fincher for 1 minute.

Mr. FINCHER. Thank you, Madam Chairwoman. I appreciate the opportunity to participate in the discussion and examination of the proposed rules to implement Basel III capital standards.

I am also pleased that Mr. Greg Gonzales, commissioner of the Department of Financial Institutions in Tennessee, is here to share his views on these proposed rules on Basel III.

Madam Chairwoman, as I begin to review these proposed rules and hear from my constituents in Tennessee, I can't help but think of the law of unintended consequences. It seems to me that much of the legislation and hearing activity in this committee results from the unintended consequences of previous laws that were intended to do one thing but ended up doing another.

I have heard from banks all across Tennessee and the concerns about the impacts these proposed rules would have on the economies of their communities. The message I have been hearing is that these rules, as written, will hurt economic growth and slow down our already fragile economy. I hope, as we examine these rules, that we remember to do no harm.

I look forward to the testimony this morning and thank the chairwoman for this hearing. I yield back.

Chairwoman CAPITO. The gentleman yields back.

Our final opening statement comes from my friend and colleague, Ms. Hayworth from New York. We will miss her on our committee and in Congress. I consider her a very good friend, and I want to thank her for her service.

I am very generous here: 1 minute, Ms. Hayworth.

Dr. HAYWORTH. Thank you, Madam Chairwoman, for your generosity and for your commitment and service in so many ways. And I can't wait to see what your future holds for all of us and our Nation.

Thanks to our witnesses on both panels today.

Obviously, from the State of New York, I represent the Hudson Valley. Capital standards and those rules and the potential unintended consequences of those rules have profound consequences for the economy of my State and Hudson Valley in particular.

Our economy, as we know, already faces serious headwinds from our link with Europe, and from our own debt crisis, from our own fiscal cliff. And it is certainly important that we honor and reflect the agreements that we have with our international partners on standards. It is also crucial that our Congress ensure that standards for capital and liquidity in the United States reflect our best interests and concerns.

So I look forward to your testimony and, in particular, how you address the issues that our community bankers and insurers have raised with folks like me. Thank you so much again.

And thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

With that, we will begin our witness testimony. I want to thank all the witnesses. I will introduce, and some other Members are going to introduce, some of the panel, but I will introduce each of you before you give your 5-minute statement.

For the first panel, our first witness is Mr. George French. He is the Deputy Director of the Division of Risk Management Supervision at the Federal Deposit Insurance Corporation.

Welcome, Mr. French.

STATEMENT OF GEORGE FRENCH, DEPUTY DIRECTOR, POLICY, DIVISION OF RISK MANAGEMENT SUPERVISION, FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

Mr. FRENCH. Thank you. Good morning, Chairwoman Capito, Chairwoman Biggert, Ranking Member Maloney, Ranking Member Gutierrez, and members of the subcommittee. I am pleased to testify on behalf of the FDIC about the agency's proposed regulatory capital rules. And my statement will focus on the two notices of proposed rulemaking (NPR) that apply to community banks and some of the comments that we have received.

One of these NPRs deals with the Basel III capital reforms. The core elements of Basel III would strengthen the quality of bank capital and increase its required level. These are basic concepts of capital adequacy that are relevant for any bank, and the Basel III NPR would apply them to all insured banks.

The Basel III reforms also include a number of complex provisions that are targeted at large, internationally active banks. We have proposed to apply these only to the largest banks, so these banks would need to comply with the basic changes to the definition and level of capital that are proposed for all banks and also with the additional standards that address the unique issues faced by large banks.

The Basel III NPR also preserves the fundamental role of the U.S. leverage ratio. The FDIC strongly supports the introduction of the leverage ratio in the Basel framework as a transparent and objective measure of capital adequacy.

The second NPR that is relevant for community banks is the Standardized Approach NPR. It proposes a number of changes to

the way banks compute risk-weighted assets and removes references to credit ratings, consistent with the Dodd-Frank Act. I do want to clarify that the changes to risk-weighted assets in this Standardized Approach NPR are not part of the international Basel III reform package.

The FDIC has devoted significant efforts to outreach and technical assistance to help community banks understand how these proposals may affect them. We have received more than 2,000 comments at last count, and many of these comments express concern that the proposals will negatively affect community banks' ability to serve the credit needs of their local communities. As the primary Federal regulator of the majority of community banks, the FDIC takes these comments very seriously.

In the last 5 years, we have seen over 460 insured banks fail and many hundreds more in problem-bank status. This painful episode has imposed significant costs on our national and local economies and illustrates the importance of banks having a strong capital base so that they can continue to lend in their communities even during periods of economic adversity.

Now, many commenters do acknowledge the importance of strong bank capital, but they also have concerns about specific aspects of the proposals, their complexity, or the totality of their potential effects. Among the more frequently mentioned specific issues are the residential mortgage rules and the Standardized Approach NPR and their interaction with the Dodd-Frank mortgage rules. In the Basel III NPR, many commenters have focused on the proposed treatment of available-for-sale debt securities and many others on the phaseout of preexisting trust-preferred securities of smaller banking organizations.

Careful review of these and other comments is a critically important part of our process that gives us a better understanding of the potential unintended consequences and costs of these proposals. It is important to note that we have not reached decisions on any of these matters. These are proposed rules, not final rules, and we anticipate making changes in response to comments.

The basic purpose of the Basel III framework is to strengthen the long-term quality and quantity of the capital base of the U.S. banking system. In light of the recent financial crisis, that would appear to be an appropriate and important goal. However, that goal should be achieved in a way that is responsive to the concerns expressed by community banks about the potential for unintended consequences.

This concludes my statement.

[The prepared statement of Deputy Director French can be found on page 148 of the appendix.]

Chairwoman CAPITO. Thank you.

Our next witness is Mr. Michael S. Gibson, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System.

Welcome, Mr. Gibson.

STATEMENT OF MICHAEL S. GIBSON, DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. GIBSON. Thank you, Chairwoman Capito, Chairwoman Biggert, Ranking Member Maloney, Ranking Member Gutierrez, and members of the subcommittees. Thank you for the opportunity to testify on the proposed interagency changes to the regulatory capital framework for U.S. banking organizations.

The recent financial crisis revealed that too many U.S. banking organizations were not holding enough capital to absorb losses during periods of severe stress. In addition, some instruments that counted as capital were not able to absorb losses as expected. In short, banks were too highly leveraged. In response to the lessons of the crisis, the banking agencies' capital proposal would increase both the quantity and quality of capital held by banking organizations of all sizes.

Another lesson from the crisis was that the largest banking organizations were the most severely impacted. As a result, many items in the agencies' proposal and in other regulatory reforms are appropriately focused on larger banking firms and would not apply to community banking organizations.

We have assessed the impact of these proposed changes on banking organizations and the broader financial system. These analyses found that the stronger capital standards in our proposal would significantly lower the probability of banking crises and their associated economic losses while having only a modest negative effect on gross domestic product and the cost of credit. The modest negative effects would be mitigated by the extensive transition periods provided in our proposal.

Our impact analysis also showed that the vast majority of banking organizations, including approximately 90 percent of community banking organizations, would not be required to raise additional capital because they already meet the proposed higher minimum requirements on a fully phased-in basis. Our impact analysis is appended to my written testimony.

Community banking organizations play a vital role in the U.S. financial system. They can provide relationship-based lending in their local communities in a way that larger institutions would find difficult to duplicate. In developing the proposal, the agencies sought to strike the right balance between safety and soundness concerns and the regulatory burden associated with implementation, including the impact on community banking.

We also conducted extensive industry outreach across the country, and we provided a tool to help smaller organizations estimate their capital levels under the proposal. As we consider the large volume of comments submitted by the public, the Federal Reserve will remain sensitive to concerns expressed by community banking organizations.

Community banking organizations are particularly concerned about the proposed treatments of unrealized gains and losses on securities, otherwise known as AOCI, and residential mortgage exposures. They believe that elements of our proposal do not adequately take into account the community banking business model and that some aspects would have potential disproportionate effects on their

organizations. We will be mindful of these comments when we consider potential changes to the proposal, and we will work to appropriately balance the benefits of a revised capital framework against its costs.

The proposal would apply consolidated capital requirements to all assets owned by a depository institution holding company and its subsidiaries, including assets held by insurance companies. By treating all assets equally, the proposal would eliminate incentives to engage in regulatory capital arbitrage across different subsidiaries of the holding company. The proposal is also consistent with the Collins Amendment in Section 171 of the Dodd-Frank Act, which requires that bank capital requirements be a floor for depository institution holding company requirements.

Depository institution holding companies with insurance activities have raised concerns that the proposed regulatory capital requirements are not suitable for the insurance business model. The Federal Reserve takes these comments seriously and will consider them carefully in determining how to appropriately apply regulatory capital requirements to depository institution holding companies with significant insurance activities.

We are working as quickly as possible to evaluate the many comments and to issue a final rule that would provide appropriate transition periods to come into compliance.

Thank you for the opportunity to describe the Federal Reserve's efforts to reform the regulatory capital framework for U.S. banking organizations, and I will be happy to answer any questions you have.

[The prepared statement of Director Gibson can be found on page 176 of the appendix.]

Chairwoman CAPITO. Thank you.

Our next witness is Mr. John Lyons, Chief National Bank Examiner, Office of the Comptroller of the Currency.

Welcome, Mr. Lyons.

STATEMENT OF JOHN C. LYONS, SENIOR DEPUTY COMPTROLLER, BANK SUPERVISION POLICY, AND CHIEF NATIONAL BANK EXAMINER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. LYONS. Thank you.

Chairwoman Capito, Ranking Member Maloney, Chairwoman Biggert, Ranking Member Gutierrez, and members of the subcommittee, I appreciate the opportunity to discuss the proposed capital rules issued by the Federal banking agencies and their potential impact on the industry.

We have received extensive comments on the proposals from banks of all sizes. In response to the concerns raised by commenters, we announced earlier this month that we will delay the January 1st effective date.

We are especially mindful of the concerns the community bankers have raised about the potential burden and the impact these rules could have on their institutions.

Our goal is simple: to improve the safety and soundness of our Nation's banking system by ensuring that banks of all sizes have

sufficient capital to weather adverse conditions and unforeseen losses.

Strong capital plays a vital role in promoting financial stability and moderating downturns by facilitating banks' capacity to lend. During the recent cycle, the banks that were best able to meet the credit needs of their customers and communities were those with strong capital bases. This underscores the principle that higher capital standards that apply to all banks is essential to the financial strength of the industry and our Nation's economy.

Capital rules also need to reflect risks appropriately. And so, under the proposals, riskier loans, such as certain types of nontraditional mortgages, would require more capital. We believe the proposals reinforce the key objectives of promoting financial stability and requiring higher capital for riskier firms and activities.

The June rulemaking package consists of three notices of proposed rulemakings. Each NPR calibrates requirements to the size and riskiness of institutions so the larger banks will hold more capital and meet stricter standards than smaller banks. These are not one-size-fits-all regulations.

The first proposal introduces a new measure for regulatory capital called common equity Tier 1 and two new capital buffers: a capital conservation buffer that would apply to all banks; and a countercyclical buffer that would apply only to the largest institutions.

For community banks, this would result in a common equity Tier 1 requirement of 7 percent of risk-weighted assets. For large, internationally active banks, this requirement could be as high as 13 percent when combined with a SIFI surcharge that is being considered internationally.

The second proposal, the Standardized Approach NPR, would modify certain risk-weighting so that riskier loans and activities require more capital. Here, two distinctions are made between small and large banks as certain provisions of the NPR, such as those related to securitization and credit risk mitigation, would have little or no application to most community banks.

The third proposal, the Advanced Approaches NPR, applies only to the largest internationally active institutions and does not affect community banks.

To reduce possible adverse effects, especially for community banks that have less access to capital market sources of capital, the proposals include lengthy transition provisions and delays in effective dates.

Our preliminary assessment is that many community banks hold capital well above the existing and the proposed regulatory minimums. Nevertheless, we took steps to maximize opportunities for community bankers to learn about and comment on the proposals. These steps included short summaries aimed at community banks, extensive outreach with community bankers, and a tool to help them assess the impact of the proposals.

While we have received comments on many issues, three overarching concerns have been raised. First, many have cited the complexity of the rules. Community bankers, in particular, have questioned whether the proposals should even apply to them.

Second, many have raised concerns about including unrealized losses and gains and available-for-sale debt securities and regulatory capital and the volatility that could result in capital levels and other limits tied to regulatory capital, such as legal lending limits.

Third, bankers have expressed concerns about their record-keeping burdens resulting from the proposed use of loan-to-value measures for residential mortgages and the higher risk-weightings that would be assigned to balloon residential mortgages.

As we consider these issues, we will continue to look for ways to reduce burden and complexity while maintaining our key objectives of raising the quantity and quality of capital and matching capital to risk. These enhancements will lead to a stronger, more stable financial system.

I appreciate your interest in this matter and would be happy to answer your questions.

[The prepared statement of Senior Deputy Comptroller Lyons can be found on page 248 of the appendix.]

Chairwoman CAPITO. I thank the gentleman.

I will now yield to Mr. Fincher to introduce our next witness.

Mr. FINCHER. Thank you, Madam Chairwoman.

It is my honor to introduce Mr. Greg Gonzales, commissioner of the Tennessee Department of Financial Institutions.

Commissioner Gonzales is a native of Cookeville, Tennessee, and received his law degree at the University of Tennessee in 1984. Commissioner Gonzales has served at the Tennessee Department of Financial Institutions since 1986 and was appointed to the position of commissioner in 2005.

In his position with the department, Commissioner Gonzales is the chief regulatory officer of Tennessee's 157 banks, 101 credit unions, 8 trust companies, and hundreds of other financial service companies. In 2011, Mr. Gonzales was reappointed to his position by Tennessee Governor Bill Haslam.

Commissioner Gonzales is here before us this morning representing both the citizens of Tennessee and as chairman of the Conference of State Bank Supervisors.

It has been a privilege to get to know Commissioner Gonzales and his staff. His office is a great resource to me and my staff as this committee works on issues, such as Basel III, that impact financial institutions across all of our congressional districts.

I am pleased the committee invited Mr. Gonzales to testify before this panel today, and I look forward to his testimony.

Chairwoman CAPITO. Thank you.

Welcome, Mr. Gonzales.

STATEMENT OF GREG GONZALES, COMMISSIONER, TENNESSEE DEPARTMENT OF FINANCIAL INSTITUTIONS, ON BEHALF OF THE CONFERENCE OF STATE BANK SUPERVISORS (CSBS)

Mr. GONZALES. Good morning, Chairwoman Capito, Chairwoman Biggert, Ranking Member Maloney, Ranking Member Gutierrez, and distinguished members of the subcommittees. Thank you for the opportunity to testify today on one of the most significant public policy matters facing the banking industry.

CSBS believes it is in all of our best interests for the Federal banking agencies to make significant changes to both the Basel III and the Standardized Approach proposals. These proposals would introduce sweeping changes to the regulatory capital framework and would significantly impact banks' credit allocation decisions and tolerance for risk.

As currently drafted, these proposals would have significant and negative consequences for local, State, and national economies. To be clear, State regulators absolutely support elevated and enhanced capital requirements. However, we believe Federal banking agencies should address these issues outside of the Basel III process and should apply Basel III only to the largest internationally active banks.

We are concerned that the proposals are too complex and highly reactionary to the latest financial crisis. As regulators, we must seek an appropriate balance. We must ensure safety and soundness of the entities we regulate, but we must also provide a system of supervision that still allows these entities to serve their communities and achieve economic success.

Banks must have the possibility of failure in order to have the opportunity for success. We believe the capital proposals will inhibit banks' ability to take prudent risk. For most banks, risk management is based on an inherent understanding of the underlying credit risk, a deep knowledge of its customer base, and an alignment between the success of the bank and its customers.

It is important to remember that many institutions do not treat loans as anonymous commodities and that these proposed rules will have real consequences for institutions and communities.

Back in Tennessee, there is a rural community that has one small bank. You probably have a similar community in your district. The bank has been around for about 100 years and provides a vital channel of credit for its residents, including mortgages. The president of that bank recently shared with me that, based on the proposed rules, he will have to limit the number and volume of loans it can originate.

We owe it to these institutions to ensure the policies we develop do not unnecessarily impede their ability to serve their communities. I am hearing this all over my State, and my colleagues have described it all over the country. We need to seek policies that focus on improving risk management and supervision, not on trying to steer individual credit decisions.

Furthermore, we need to encourage a supervisory process that prudently supports economic recovery, not policies that will further suppress the flow of credit or drive business from the regulated deposit system.

State regulators are also concerned about the lack of sufficient understanding regarding the impact of these proposals. We need to clearly understand how these proposals will change the type of credit available, the manner in which banks lend, and the full impact on economic recovery and job growth.

Lawmakers, Federal banking agencies, and State supervisors share the collective goal of supporting the effort to strengthen our financial system and generate stability for the American people.

Unfortunately, the Basel III and Standardized Approach proposals run counter to this goal.

I believe that, with meaningful debate and significant engagement, we can determine the appropriate approach to capital policy development for a diverse economy and a diverse financial system. CSBS stands ready to work with Members of Congress and our Federal counterparts in seeking the appropriate regulatory balance.

Thank you for the opportunity to provide my views here today. I look forward to responding to any questions you may have.

[The prepared statement of Commissioner Gonzales can be found on page 198 of the appendix.]

Chairwoman CAPITO. Thank you, Mr. Gonzales.

Our next witness is Mr. Kevin M. McCarty, insurance commissioner, Florida Office of Insurance Regulation, on behalf of the National Association of Insurance Commissioners.

Welcome, Mr. McCarty.

STATEMENT OF KEVIN M. MCCARTY, COMMISSIONER, FLORIDA OFFICE OF INSURANCE REGULATION, AND PRESIDENT, THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC), ON BEHALF OF NAIC

Mr. MCCARTY. Thank you, and thank you for the opportunity to testify today. My name is Kevin McCarty, and I am the insurance commissioner from the State of Florida. I am also the president of the National Association of Insurance Commissioners.

Increasingly complex and global financial institutions pose challenges for regulators to provide consumers with the appropriate level of protection while not stifling competition, innovation, or growth. The NAIC recognizes that certain insurance groups have chosen to engage in the business of banking, which could subject them to consolidated supervision by the Federal Reserve. However, we are concerned that the current capital proposal appears to apply a one-size-fits-all bank-centric approach to these institutions, whose banking activities typically represent only a small portion of their overall business and overall assets.

The prospect of bank-centric regulatory rules being imposed on insurance groups is problematic, and it is critical that the regulatory walls around legal entity insurers that have successfully protected policyholders for decades not be jeopardized. Insurance products and insured assets and liabilities are fundamentally different from banking. Banking products involve money deposited by customers and are subject to withdrawal on demand at any time.

Insurance policies involve upfront payments in exchange for a legal promise to pay benefits upon specific loss-triggering events in the future. The very nature of insurance significantly reduces the potential of a run-on-the-bank scenario. Insurance products, unlike banking products, do not transform short-term liabilities into longer-term assets. This is a critical distinction. A key reason many other financial firms suffered during the financial crisis was that the duration of assets and liabilities were not matched in a way that enabled them to fund their liabilities when they became due.

The national State-based system of insurance regulation was specifically designed to address the unique nature of insurance prod-

ucts. The system's fundamental tenet is to protect policyholders by ensuring the solvency of the insurer and its ability to pay claims.

My written testimony details the key aspects of our insurance solvency regulatory framework, including the licensing process, detailed reporting and disclosure requirements, conservative accounting standards, continuous financial analysis, our own risk-based capital system, and a windows-and-walls approach to group supervision.

It is critical to emphasize that while capital requirements are important, such requirements alone cannot ensure the safety and soundness of complex financial institutions. Parallel to the development of the Basel III rules we are discussing today, there were some in the international community in favor of universal global capital standards for insurance groups. We fear the same overreliance on capital could become a reality in our sector with no diversity of regulation to mitigate the wrong incentives or to prevent systemic risk-taking.

The existence of global capital standards in the banking sector did not prevent the last crisis and did little to prevent large institutions from becoming larger while chasing each other off their own fiscal cliff. Overlaying such an approach on the insurance sector is not likely to yield better regulation of banks or thrifts owned by insurers and could, in fact, exacerbate the next crisis.

While the focus of our comment letter on the rules was to provide technical clarifications on the specific insurance-related questions, I also want to emphasize our interest in promoting an open dialogue with the other agencies on this panel to help them better understand the insurance business model and our regulatory framework. We believe it is imperative that in their efforts to regulate thrift and holding companies, Federal agencies should have all the information necessary to craft rules appropriate to the risk profiles of the regulated entities.

To that end, we have provided input on the proposed definition of separate accounts which may be in conflict with State law and the treatment of policy loans which may need to be reevaluated for risk-weighting purposes. We also discuss the use of risk-based capital for managing underwriting risk, and the requirements for surplus note reporting, and lay out the differences between statutory and GAAP accounting.

Of particular concern is the proposed treatment of risk-based capital (RBC). RBC is a trigger for intervention, not a minimum standard. Given that insurers typically hold significantly more capital than RBC trigger levels, the proposed rule suggests either a misunderstanding of an insurer's capital or an implication that capital above the minimum RBC levels is excess and therefore may be available to support capital deficiencies created by affiliated banks or thrifts. We strongly object to policyholder funds being used to subsidize losses of a holding company, bank, or thrift without insurance regulator approval.

In conclusion, we look forward to sharing our experience and expertise regulating U.S. insurers with our Federal and international colleagues, which will assist them in developing a regulatory approach that appropriately captures the complete risk profile of an insurance enterprise while respecting regulatory walls already in

place to protect our policyholders. Thank you again for the opportunity to testify today, and I look forward to answering your questions.

[The prepared statement of Commissioner McCarty can be found on page 296 of the appendix.]

Chairwoman CAPITO. Thank you, Mr. McCarty.

I am now going to recognize myself for 5 minutes to begin the question portion. This is directed to the three regulators—the Fed, the OCC, and the FDIC—who are with us today. I was wondering, have any of your agencies conducted a cost-benefit analysis? We have heard, and we are going to hear on the second panel, too, I think, the cost to the institutions, but a cost-benefit analysis which would ensure that the new capital requirements achieve that appropriate balance between safety and soundness and what economic effects there might be.

I will start with you, Mr. French, from the FDIC.

Mr. FRENCH. Thank you. We have conducted various kinds of analysis. We have done some statutorily required analysis of the cost of the proposals for small institutions, banks under $175 million in assets. Those analyses really looked at the compliance costs. So—

Chairwoman CAPITO. And briefly, what did that show?

Mr. FRENCH. I think we concluded that there would be substantial, as measured by a percentage of non-interest income, a substantial cost, particularly for the implementation of a standardized approach or a large number of small institutions. Having said that, that is an initial analysis that we are getting comments on and I think we are getting a lot better appreciation through the 2,000 comment letters of more specific aspects of different aspects of the proposals.

In terms of the economics of lending and growth and all that, there has also been a lot of work done that the agencies participated in with the Basel Committee, looking at the effect of higher capital requirements. I think the general consensus there, as Mr. Gibson outlined, is that there is a substantial benefit to the economy from reducing the incidence of banking crises, and that outweighs the sort of transitional cost of getting the industry to a higher level, especially here in the United States where banks are already at a fairly high level of capital.

Chairwoman CAPITO. Mr. Gibson, is there a cost-benefit analysis at the Fed?

Mr. GIBSON. I don't have too much to add to what Mr. French said. As he said, we did do an analysis of the impact of the proposal which looked at the macroeconomic benefits of higher capital, weighed against the costs. We did find that the benefits outweighed the costs on the macroeconomic level.

Chairwoman CAPITO. Was this at institutions of various sizes or was it the—

Mr. GIBSON. This was an aggregate economy-wide analysis. We also looked at the impact on different size categories of banks. As I mentioned in my remarks, many banks already meet the higher capital requirements. Large banks have built a lot of capital in the last few years and will continue to build capital to meet the pro-

posed requirements. We estimate that 90 percent of community banks already meet the higher capital requirements.

I think it is important to say, as Mr. French said in his remarks, that we are learning a lot from the comment process about the compliance costs of everything that is contained in the proposal. So beyond just meeting the capital requirements, those additional costs are something where we are learning a lot from the comments and we will take that into account going forward as we work toward the final rule.

Chairwoman CAPITO. Mr. Lyons?

Mr. LYONS. I really don't have much to add. All three agencies did a similar type analysis and we all came up with similar conclusions in terms of impact to the industry and to the broader economy. And I would just reinforce the fact that as we go through the comment period, we are receiving additional information from the banks. We will include that in a further analysis before we issue any type of final rule.

Chairwoman CAPITO. I guess it is a little bit of a disconnect for me that on the front side—since I know that you all reach out to your institutions quite regularly—these considerations couldn't have come up as a surprise to you in the comment period. But that is just a comment on my part.

The other thing I would like to ask quickly is, after the first of the year we are going to be getting the definition of a QM and it is going to have a significant impact on every financial institution that writes mortgages. And part of the Basel III, as I understand it, the residential mortgage portion of a bank's portfolio will have significant influence on how you calculate the risk. Have you taken into consideration how the definition of a QM could influence the standards that you are requiring in these new capital standards? Mr. French, I will ask you first.

Mr. FRENCH. We certainly looked at the proposed QM standards as we were developing those mortgage proposals and these rules. And having said that, we have gotten sort of the message from the commenters that the QM rules are still uncertain, no one knows what their final form will be.

Chairwoman CAPITO. Right.

Mr. FRENCH. And people are very concerned about how these two will interact. So I think those are very significant observations that we have to look at as we develop how to proceed with these rules. We recognize the close linkage and the importance and the potential interactions that have to be taken into account.

Chairwoman CAPITO. Does anybody else have a comment on that?

I would urge great caution here because one of the things that we have all heard about from our bankers large and small is that if the QM is written too narrowly or not to the satisfaction of compliance officers and regulators, the caution that will be exercised by the financial institutions could really hurt the housing market and hurt those who may be on the bubble a little bit in terms of whether they can secure a mortgage.

And so, I think this is an exceedingly important topic and hopefully—I am glad to know you are looking at it closely. I know it

is very complicated, but at the same time, it is extremely important.

I recognize Mrs. Maloney for 5 minutes.

Mrs. MALONEY. Thank you very much.

I would like to ask Mr. Gibson from the Federal Reserve about including regional and community banks in Basel III. Our banking system is very different from Europe and Japan and China, which is very much dominated by large global banks. We have large global banks, but we also have community banks. And in the financial crisis, I would say they were the ones who continued to provide credit to our communities and to respond to localities. Many have expressed concern that the way it is drafted now, it will just end the existence of them, and they will be forced to merge and everything else, which I don't think is a good objective.

So what is the objective of applying it to the smaller banks that are not involved in any way in international commerce? If they want to get involved, if they want to be part of the global community, then you could say they have to have these standards. But if they are serving a community and are only in the community, why in the world are we putting them into the same capital requirements? We do have the capital requirements of Dodd-Frank that apply to them. So what policy objective are we meeting by sweeping in the local community and small regional banks?

Mr. GIBSON. I would agree that community banks did and continue to play a vital role in their communities. And it is certainly true that it was the large banks that had the most significant problems during the crisis. As a result, our reform package is significantly aimed at large banks and there are many requirements, both in this proposal and in other areas, that only apply to large banks. For example, our stress-testing regime only applies to large banks, and enhanced prudential standards under Section 165 of the Dodd-Frank Act only apply to large banks. Higher capital charges for trading activities and, as Mr. Lyons mentioned, eventually a capital surcharge for systemically important banks all will only apply to large banks.

Now, it is true that some of the provisions in the capital proposal do apply to all banks. Some of that is because of the requirements of the Dodd-Frank Act that apply to all banks, and some of that is an effort to raise the quality and quantity of capital for all banks. We think that strong capital is important. We are sensitive to the comments of community banks, and there are many aspects of the proposal where we have learned a lot from the comments about the details of where there might be some impacts that we need to look at, but stronger quality and quantity of capital for all banks is an important reform.

Mrs. MALONEY. Most community banks are already well-capitalized, and they are objecting to being put into the whole rule. If they want to opt in, I would say let them opt in. But if they don't and they are just serving the community, I would let them continue.

Your rules also have a dramatic effect on capital requirements, and by extension the pricing of loans, because of the new method of applying risk weights to specific asset classes, and the Basel rules allow the internationally large complex banks to create their own methods of coming up and their own models. But you are hav-

ing the regional community banks that compete against each other in local markets, they must follow the standard approach. So I am questioning the reasoning for that. And also I would say that in Dodd-Frank, we certainly intended for the regulators to notice the difference between banks and insurance companies. And yet your approach seems to create a holistic floor rather than an asset-by-asset minimum requirement or take into considerations the differences between insurance and international banking, which have been successful in our country. Why again put this added burden?

Mr. GIBSON. In the Dodd-Frank Act, Congress did direct us to set consolidated capital requirements for bank holding companies and savings and loan holding companies, including the ones that choose to own an insurance company. You are right that the requirements of the Collins Amendment in the Dodd-Frank Act do require that the bank capital requirements serve as a floor for the holding company requirements. That was a significant constraint on what was in our proposal. But also, on your first comment about the differences between Advanced Approaches where banks are estimating some of the parameters compared with the Standardized Approach, there is a floor now under the Collins Amendment that will prevent the capital requirements for large banks falling below what would be the generally applicable capital requirements, which, for example, could be the Standardized Approach.

Mrs. MALONEY. My time has expired. Thank you.

Chairwoman CAPITO. Mrs. Biggert for 5 minutes.

Chairwoman BIGGERT. Thank you, Madam Chairwoman. Mr. Gibson—and this is just a yes-or-no question—isn't the Basel III a framework that regulators of each country participating in the agreement are required to implement through more specific regulations? In other words, is there some flexibility for the regulators of each country to conform to the framework through regulations that are unique to each country?

Mr. GIBSON. Yes.

Chairwoman BIGGERT. Okay. Wouldn't it be prudent of our Federal banking regulators to provide the same kind of accommodation and courtesy to our financial institutions, such as insurance companies and State insurance regulators, within the Basel III rules? That is a yes or no, again.

Mr. GIBSON. Yes, we take the Basel agreements and we implement them according to our domestic circumstances.

Chairwoman BIGGERT. Is there accommodation and courtesy to the financial institutions or the insurance companies and State insurance regulators?

Mr. GIBSON. Yes.

Chairwoman BIGGERT. Yes. Okay.

Mr. Gibson. We tailor it to our domestic circumstances.

Chairwoman BIGGERT. All right. Are your counterparts in Europe developing or applying Basel III, like regulations to insurance companies?

Mr. GIBSON. Mr. McCarty probably knows more about what the insurance regulators in Europe are doing. But for us, we are required to impose consolidated capital requirements on bank holding companies and savings and loan holding companies, some of which are owning insurance companies.

Chairwoman BIGGERT. Then, I will ask Mr. McCarty. Are the counterparts in Europe developing or applying Basel III, like regulations to insurance companies?

Mr. MCCARTY. Europeans are in the process of adopting Solvency II, which provides for a consolidated look at the group. The companies are allowed to use internal modeling to determine their target capital standards, which is to contemplate all the risks, which is very, very different than the U.S. regulatory model, which is based upon the individual legal entity, and we look at walling off that entity, whereas the European model contemplated under Solvency II looks at group capital determined by an internal model.

Chairwoman BIGGERT. Okay. Then a fundamental objective of Dodd-Frank was to reduce systemic risk, and I am concerned that the Fed's Basel III proposal would result in bank clearing members having to hold—that is, like, the Merc—having to hold significantly more capital when their customers use less risky instruments, which seems just the opposite of the way it should be. This backwards incentive could make it more expensive to use exchange traded futures and customized swaps. Shouldn't the rule be designed to encourage the use of lower risk profile products and not discourage it?

Mr. GIBSON. It is an important aspect of regulatory reform to encourage central clearing of OTC derivatives, and part of the Basel III accord is to make sure that capital incentives are in place to do that. We have received a lot of comments on that aspect of our proposal and we are certainly looking at those to make sure we get the incentives in favor of central clearing.

Chairwoman BIGGERT. In my opening statement, I asked if the Federal Reserve is committed to improving the Basel III rules.

Mr. GIBSON. Yes.

Chairwoman BIGGERT. Yes. How long is all this going to take?

Mr. GIBSON. We received a lot of comments. We extended the comment period longer than it was originally open for to make sure that many interested parties had a chance to comment. At this point, we are working through the comments and working as quickly as possible towards a final rule, but I wouldn't want to give a prediction of a specific date.

Chairwoman BIGGERT. You said there is a lot of comments. Is that 1,000, 2,000, 5,000?

Mr. GIBSON. We counted around 2,500.

Chairwoman BIGGERT. Twenty-five hundred. I yield back.

Chairwoman CAPITO. Ms. Waters for 5 minutes for questions.

Ms. WATERS. Thank you very much, Madam Chairwoman.

A question for Mr. French of the FDIC. One area that I am particularly focused on is the proposed risk weights on mortgages, particularly as they relate to small and community banks and community development financial institutions. We all recognize that imprudent mortgage lending was at the center of the last financial crisis. But by and large, small and community banks as well as CDFIs didn't engage in the kind of activity that really created systemic risk in our economy in 2008. Their lending was much more likely to focus on meeting the long-term needs of the borrower and facilitating a lasting customer relationship. We have also seen that small and community banks have been much better in terms of

providing loan modifications to borrowers than some of the larger mortgage servicing operations.

So with that said, I want to ask about the proposed changes in risk weights on mortgages under the Standardized Approach as it relates to small and community banks and CDFIs. As you move towards the finalized rule, how are you acknowledging the unique business models of these institutions in the mortgage lending space?

Mr. FRENCH. Congresswoman, we have heard these comments throughout 2012. Ever since we proposed the rule, we have met with many, many community banking groups face to face and CDFI bankers as well. So what we are hearing is that the rules will significantly change the economics of the business model and affect loans that they have been making successfully for many years in ways that they don't think they will be able to continue.

That is what we are hearing. That concerns us greatly. So we are in a position here where I cannot prejudge what the outcome of the rulemaking process would be, but we do intend to make changes to the rule in response to comments, and this is certainly one of the areas that is of great importance and that we are looking at very carefully with our fellow—

Ms. WATERS. Thank you very much.

Mr. Gonzales, can you weigh in on this and elaborate on what you said in your testimony about how mortgage securitization does not encompass the entirety of the mortgage lending industry? Further, what do you think the impact of the Standardized Approach would be on the underserved areas?

Mr. GONZALES. In my discussions with community banks in Tennessee, a number of them are making the 5- or 7-year adjustable rate mortgage, maybe a balloon payment. Those are bread and butter products that community banks, just as you have alluded to, have been making for a long time, and have done it well for many, many years. I have had some of these institutions tell me that—in fact the one that I alluded to in my opening statement asked me, what am I going to tell some of my customers when I have to pull back in this area because the risk-weighting is basically telling community banks we don't want you in this area? It is not giving enough differentiation between the largest institutions in this country and the smallest. So that gives us a great concern because some of these areas that I am talking about are basically served by the community bank that is located there, and if it is not able to do the work, then there are big questions as to who is going to be served.

Ms. WATERS. Mr. Gonzales, help me to understand the definition of a community bank. Some have proposed that the definition extends to banks with upwards of $50 billion in assets. This strikes me as a little high. How can we strike the right balance?

Mr. GONZALES. In Tennessee, most of our institutions are less than a billion. We do have some that are above which have the characteristics of a community bank in their decision-making and who they serve. So there are certain situations where there are institutions of some size that do have the characteristics of a community bank. I don't have an absolute definition for you, but we are relying on them heavily in my State and in States all over this

country, and we certainly need to deal with these rules in a way that allow them to go forward in a positive way.

Ms. WATERS. What about any of the other panelists, do you have any thoughts about what a community bank, how it should be defined, and is $50 billion too high? What is the right balance? Anybody?

Mr. GIBSON. I would agree with Mr. Gonzales that it is important to look at the characteristic of the bank in addition to just the size. Internally, we have a cut-off around $10 billion, but depending on the characteristics of the bank, there are certainly banks larger than $10 billion that behave a lot like community banks.

Ms. WATERS. Thank you, Madam Chairwoman. I yield back.

Chairwoman CAPITO. Thank you.

Mr. Renacci for 5 minutes.

Mr. RENACCI. Thank you, Madam Chairwoman. And I want to thank the witnesses for being here.

I am going to start, but this is more of a comment. I know you have heard a lot from many Members, my colleagues here about community banks, and I know many of you testified in front of the Senate that the vast majority of community banks will already be compliant with the capital rules and won't suffer any ill effects. I think you are hearing a lot of those comments from all of us, that community banks are very important to the communities and those that they serve that and we need to make sure that, just as you have stated, they will not suffer any ill effects. We are hoping that is strongly considered as you move forward.

But I want to change the discussion a little bit on the impact the proposal will have on the economy, my constituents, and really credit in the marketplace. Obviously, as the cost of doing business goes up, consumers will end up footing the bill or being left out of the market altogether. What studies have you conducted that specifically address the impact on consumers? What will be the impact of Basel III on mortgage lending? Have you determined what the additional costs of Basel III will be for consumers with lower credit scores or FICA scores? And have your agencies undertaken a comprehensive study of the banks they supervise to estimate the compliance costs of this proposal? Let's start with Mr. Gibson.

Mr. GIBSON. We have estimated some of the elements of the impact that you talked about. As I said earlier, we compared the benefits of higher quality and quantity of capital in terms of a stronger financial system, fewer financial crises, and compared that with the costs in terms of higher costs of credit and growth of GDP. We determined—this was the joint analysis with the Basel Committee—that the benefits outweighed the costs, but in addition to some of the elements that you mentioned, we have been getting a lot more detailed feedback through the comment process where we are learning a lot about impacts of different parts of the proposal. And those are very helpful and useful as we work towards the final proposal. We are definitely taking those comments into account and we want to make sure we balance the impact against the benefits of a safer and stronger financial system.

Mr. RENACCI. Mr. French?

Mr. FRENCH. I don't think I have a great deal to add to that. You mentioned the area of mortgages in your question and I think that

is a particular example where the goal is to be more risk sensitive to get more capital for some of the alternative structures, but then when you look at the comment letters you are seeing a lot of useful information about areas where we might need to reconsider. So I think that is a good example of what Mr. Gibson is talking about.

Mr. RENACCI. Mr. Gonzales, you say in your testimony you believe that there—we do not believe there is sufficient understanding of impact these proposals would have on the industry and credit availability. Do you agree with that comment, because that is pretty much what I am trying to hit on.

Mr. GONZALES. I don't think there is enough information to determine the impact of these rules. We certainly know that, for instance, the FDIC, as I think has been mentioned, has engaged in a study of $175 million asset institutions and less and reflected a significant impact on those institutions. So if there is additional work that is done on the rest of the industry, it may prove that there is also troublesome information as far as the impact on additional institutions in this country from these rules.

Mr. RENACCI. Mr. Lyons, do you have anything to add?

Mr. LYONS. As I said earlier, the three Federal agencies did a very similar analysis and came up with similar conclusions. And as additional comments come in we will take these into consideration as we do additional analysis.

Mr. RENACCI. Thank you. This may have been answered before, but I guess I didn't hear the answer. When it comes to insurance companies, they have traditionally been regulated at the State level, yet the proposed rule would apply to holding companies that own insurance companies. I understand that dual oversight can exist, but how will disputes between Federal and State regulators be reconciled? Anyone want to—

Mr. GIBSON. We are currently the supervisor of bank holding companies and now, after the Dodd-Frank Act, of savings and loan holding companies, so we have a lot of experience working with functional regulators in banking like the OCC or the FDIC, as well as with insurance regulators because some bank holding companies have owned insurance companies before. We focus on looking at the consolidated company and capital requirements at the highest level of the consolidated firm. And in the case of insurance, the State regulator sets the capital requirement for the insurance operating company that is at the State level.

Mr. RENACCI. So how would disputes be reconciled, I guess, is who would have the—

Mr. GIBSON. Each regulator has authority over their own piece of it. In cases where it is something related to the holding company, we would have the authority and we would consult with the State regulator. And I assume in cases where it is the State-regulated insurance company that is at issue, the State insurance regulator has the authority and would use it appropriately.

Chairwoman CAPITO. The gentlemen's time has expired. Mr. Watt from North Carolina for 5 minutes.

Mr. WATT. Thank you, Madam Chairwoman. And I thank the Chairs for convening this hearing. Let me say to the Federal regulators that I share a number of the concerns that have been raised by my colleagues already about community banks. Although I am

aware of a number of small and community banks that went out of business as a result of the economic downturn or had to be reorganized or taken over by others, they are unique to our communities, and to the extent we can accommodate them, we need to be trying to do that. And I am happy to hear that you all have heard the comments and are taking those into account as you move toward adopting the final rule. So I won't belabor that. I share the concerns and it sounds to me like you are taking those concerns into account and will try to address those.

I do want to address an issue that has been raised by one of my local banks, which is what appears to me to be a legitimate concern about the treatment of defined benefit pension plans in the calculation of Tier 1 capital. This particular bank, which I won't identify, has a defined benefit plan and is in the unique position, I guess, that it is overfunded. And they apparently have gotten an ambiguous response, or it is ambiguous in the rule, in the proposed rule whether that excess capital or excess funding would be allowed to be counted toward their capital. So if you all could comment on whether you can make that explicit or whether, if you can't make it explicit, there is some reason that it shouldn't be explicit, that would be helpful to me in addressing the concern that they have raised.

Mr. FRENCH. We have certainly heard about this issue. From a safety and soundness perspective, the overall goal was to have assets that can absorb loss. So in this particular case of the overfunded pension fund asset, the question is, is this reflective of sort of estimates of what is out there in the future. So there is the safety and soundness case, it may not be an asset, but is as reliable as other assets. So that is the reason for the proposal to deduct it.

We have also heard comments from a number of banks about their concern that this is going to disincent them from offering pension plans and that could have an unintended consequence. So we are keenly aware of the issue.

Mr. WATT. But don't you monitor these pension plans and the regulators don't monitor them to determine, by your own standards, whether they are overfunded or underfunded, and couldn't that overfunding be counted toward capital until there is some problem with it and then ask them to build up more capital?

Mr. FRENCH. That would be another way to address it and we would be happy to take that thought back as we look at the final rule. So like I said, it is a trade-off. We have the concern about the reliability of the asset on the one hand, and on the other hand, we have the concern about disincentives to offering these pension plans. I think the way the rules work, it actually is not so much of an issue for insured banks as it is for bank holding companies. But it is important to provide this clarity and I think you raise an important point.

Mr. WATT. This bank happens to be an insured bank, so it obviously is an issue for them. It is of particular concern to them because they think they are fairly substantially overfunded and really want to stay overfunded, which is, I think, the prudent and wise thing to do. You are either going to disincentivize people to have defined benefit plans or you are going to disincentivize them to overfund if you don't address this issue, it seems to me. And I hope

that you will take this comment back and be direct about how you plan to address it, because ambivalence in this area or a standard that is not clear is not good either. So I appreciate it.

And I yield back, Madam Chairwoman.

Chairwoman CAPITO. The gentleman yields back. Mr. Garrett for 5 minutes for questions.

Mr. GARRETT. I thank the Chair for the hearing, and I thank the witnesses as well. I apologize—I had to step out with some constituents—if one of my questions may be redundant. Let me start, though, with just a sentence or two from a speech given back in September by Thomas Hoenig, Director of the FDIC. He said this: "In judging the role of capital it is useful to look back at bank capital levels in the United States before the presence of our modern safety net. Prior to the founding of it, things were a lot simpler." And then he said, "Going forward, how might we better assess capital adequacy?" He said, "Experience suggests that to be useful capital must be simple, understandable and enforceable. It should reflect the firm's ability to absorb loss in good times and in crisis. It should be one that the public and the shareholders can understand, that directors can monitor, that management cannot easily game, and that bank supervisors can enforce. An effective capital rule should result in a bank having capital that approximates what the market would require without the safety net in place."

Not that I claim to be an expert on Basel III, I guess I question whether what we are looking at fits those requirements—simple, understandable, enforceable, and approximate what the market would require without the safety net in place. So let's get into parts of it, let's get into the issue of risk weighing and some of the aspects on that. And I throw this open to the panel. Is there any underlying data that was used or would be used to calibrate the risk weights for the various proposals? I know we had some discussion with some of the folks in the office on some of this. We are hearing that, as proposed, the risk-weighting may not accurately reflect true risk, riskiness of lending exposures, and in particular mortgages. And if that is the case, then won't failure to accurately calibrate the capital with risk results in a bank reducing overall lending going forward? So a two-part question. Anyone? Was it done and what effect will it have?

Mr. GIBSON. With respect to the proposed risk weights on mortgages, they were calibrated to the types of mortgage products where in the aggregate we saw much greater losses during the financial crisis. What we have learned from the comments, especially from the community banks, is that the experience at community banks may have been different than the experience at large banks in terms of what types of products turned out to be the riskiest. We have gotten a lot of comments on the particular risk factors we put into the risk weight proposal and we are going to look at those comments as we go forward.

Mr. GARRETT. Which is one of the aspects I could get into if I had more time, is to say this is always retrospective, looking back to see what the last crisis was as opposed to looking forward as opposed to what the markets would be, which would be constantly looking forward, which is not being done here. So do you also look at what the combination of that risk weights that you would apply

to them have on with all the other regulations that we are imposing and whether or not that will hinder, it will hinder or help, probably hinder, our ability to reduce the government's footprint or presence in the housing financial market?

Mr. FRENCH. You raise an important question about the interaction of the various parts of the Dodd-Frank Act with these rules. And in the case of mortgages, that is an extremely important issue because, as you know, we have the Qualified Mortgage (QM) rules which will come. We don't know what they are yet. The Qualified Residential Mortgage (QRM) concept for securitization. Risk retention also has to be developed, along with various other assorted rules about appraisals and other things.

Mr. GARRETT. Is that something you sit and consider?

Mr. FRENCH. Absolutely. The comment letters are very clear on this, that there is a concern about the interaction, how this is all going to fit together. And that is one of the important things we have to deal with before we make decisions about how to proceed on those mortgage.

Mr. GARRETT. I have a quote here from Mark Zandi. In Moody's Analytic, he said that the current rules that you are referring to—not yours, rules—would add 1 to 4 percentage points spending on the parameters of the mortgages being originated and the discount rates apply, and the rule as written could significantly impede the return of private securitization markets and permanently cement the government's role in housing. And so as I understand it, some of the rules that are being considered here as far as basically treating guaranteed assets of those guaranteed by Fannie Mae and Freddie Mac having a better rating risk factor than the private securitization market would once again just put the government's role in here and, as he puts it, cement us permanently in this marketplace and the private label market out of a situation. Is that something you are going to consider before final rules?

Mr. FRENCH. The issues about the role of the government and mortgage finance are certainly very important. I think I am not in a position to respond on how that is going to play out going forward. I think we have some concrete proposals about what the risk weight should be on the various assets that typical community banks hold, and we are certainly going to consider how those interact with the other Dodd-Frank provisions before we make any decisions.

Mr. GARRETT. That is the point, thanks a lot.

Chairwoman CAPITO. Thank you. The gentleman's time has expired. Mr. Miller for 5 minutes.

Mr. MILLER OF NORTH CAROLINA. Thank you, Madam Chairwoman. And, Madam Chairwoman, I wanted to compliment you on the tasteful color of your jacket today.

Mr. Gibson, just in the last few weeks, Dan Tarullo, a Fed Governor, and Bill Dudley, President of the New York Fed, have said that the biggest banks are still too-big-to-fail. If they did fail they would collapse in a disorderly heap with dire consequences for the financial system and for the economy as a whole. And as a result of that, there is a widespread assumption in the market that the government would not allow that to happen, and they can borrow money more cheaply as a result. Do you agree with that and do you

agree that is an unfair subsidy that the biggest banks get that gives them an advantage over the "small-enough-to-fail" banks that Mr. Gonzales supervises?

Mr. GIBSON. As I said earlier, we are focusing on the whole regulatory reform program, many elements are aimed at the largest banks. We require the largest banks to go through stress testing. With the Basel Committee, we are working on a capital surcharge for large banks. The ultimate goal of that is to even out the playing field so that the systemic impact that a large bank failure would have on the rest of the economy is internalized by them through things like higher capital.

Mr. MILLER OF NORTH CAROLINA. One of the ways that the Dodd-Frank Act, that Congress tried to deal with that, working closely with regulators, particularly the FDIC, was the living wills requirement. The FDIC and the Fed have now completed their first round of living wills, and Mr. Dudley in his speech in just the last few days, he said that too-big-to-fail is an unacceptable regime. But he also described the first round of living wills as the beginning of an iterative process, it confirmed that we are a long way from the desired situation in which large complex firms should be allowed to go bankrupt without major disruptions to the financial system and large costs to society. Significant changes in structure in an organization will ultimately be required for this to happen, and that the initial exercises had given the regulators a better understanding.

It seems a very complacent approach to think we can go through round after round after round of this to get it right, that the regulators can make polite suggestions, and the institutions subject to the living wills requirement can make tweaking changes, and at some point in the future, we will have credible resolution plans that won't collapse the entire economy.

The economist Simon Johnson said that he concluded from Mr. Dudley's remarks that the living wills process was "a sham, meaningless boilerplate and box checking." With still a $67 trillion shadow banking system, a lot of uncertainties in our financial system, how long is it going to take to have credible living wills, credible resolution plans? And why not now? That was to you, Mr. Gibson, since you work for the Fed.

Mr. GIBSON. I would agree with the thrust of your comments—I would agree with President Dudley's comments that the living will process is an iterative process because we are learning from the first round of living wills, we are going to go back to the institutions with feedback. It is going to be a repeated process. This is something that is completely new for us. We are working jointly with the FDIC, building a new process to use the living wills to make large firms resolvable. And, frankly, it is the first time we are doing this particular type of exercise in this level of detail. We are getting something going that is new for us and it will take a little time. But I agree with you it is urgent to get it going and it is urgent to get it right.

Mr. MILLER OF NORTH CAROLINA. Yes, "ultimately" is not a particularly harsh deadline; that seems to be kind of an indulgent deadline, to use your term. Can you give us some idea how long it is going to take before we can feel reassured that there are resolution plans in place that if one of these enormous banks that are

too-big-to-fail now gets in trouble, it won't collapse in a disorderly heap, that it will be resolved in a way that doesn't bring down the financial system and the economy with them?

Mr. GIBSON. So we have new tools, the FDIC has a new tool, the Orderly Liquidation Authority (OLA), that could be used in the event of disorderly stress at one of the largest companies. But the living will process is designed as an annual process. So there is intended to be improvement. We do have to get to the goal of being fully confident that those large institution are resolvable. We haven't put a deadline on that, but it is important to get there and to get there quickly. I would agree with that.

Chairwoman CAPITO. The gentleman's time has expired.

Mr. Miller?

Mr. MILLER OF CALIFORNIA. Thank you, Madam Chairwoman.

I guess it is just time to pick on you, Mr. Gibson, so I have a couple of questions for you, and they are not really picking, but they are focused on you. When the United States works to implement the Basel Accord, do we implement exactly like the other countries do or do we customize the rules to our banking structure so to outcomes equivalent to the Basel Accord framework? And do you agree the United States should customize them to an equivalent?

Mr. GIBSON. We do customize it, yes.

Mr. MILLER OF CALIFORNIA. So, yes, good. Under the proposed rule, the bank-centric standards will be detrimental to insurance companies. And I introduced the Collins Amendment language to that, that he introduced in the Senate which really clarifies that issue, and wouldn't it be more appropriate to apply insurance-specific capital standard to insurance companies so long as they are equivalent the capture risked as the banks do?

Mr. GIBSON. What we are doing in our proposal as required by the Dodd-Frank Act is to impose consolidated capital requirements at the holding company level.

Mr. MILLER OF CALIFORNIA. We are trying to capture equivalent risk as bank standards, isn't that the goal?

Mr. GIBSON. What we have proposed is that if the same asset is held by an insurance subsidiary of a depository institution, a holding company or a bank subsidiary, that we would have the same risk weight on that.

Mr. MILLER OF CALIFORNIA. Yes. What I am saying is you are going to appropriately apply insurance-specific capital standards to the insurance companies so that they are equally capturing the risk as banks would do, but they are different, but you are equally going to capture the risk, that is the goal, right?

Mr. GIBSON. The goal is to capture the risks. I wouldn't say it is equal because, for example, insurance companies have unique risks associated with insurance underwriting.

Mr. MILLER OF CALIFORNIA. That is what I am saying, they are different. Different risk and different standards, but you want to capture the risk equally based on their given standards.

Mr. GIBSON. Yes, the standards are different for insurance underwriting risk.

Mr. MILLER OF CALIFORNIA. That was a concern I had. Is it true that the types of assets that the insurance typically holds, such as

long-term corporate bonds, are assigned to high risk-weighting under the proposed capital standards?

Mr. GIBSON. The risk rates are different according to the riskiness of the asset.

Mr. MILLER OF CALIFORNIA. Are long-term corporate bonds assigned a higher risk?

Mr. GIBSON. Higher compared to what?

Mr. MILLER OF CALIFORNIA. Under your weighting standards that you are proposing.

Mr. GIBSON. The risk weights are based on the riskiness of the asset.

Mr. MILLER OF CALIFORNIA. How would you categorize a long-term corporate bond?

Mr. GIBSON. Riskier than a Treasury bond.

Mr. MILLER OF CALIFORNIA. That is what I am saying. They are categorized as a high risk. I am hearing these things, but I want to make sure we get them on the record, and that is what we are doing so we truly understand it. And because of the proposed rule, won't an insurer that holds long-term corporate bonds, which we are talking about, or their assets with high risk-weighting, have a lower capital ratio as a consequence of holding these assets?

Mr. GIBSON. If the riskiness of the assets goes up, then the capital ratio goes down.

Mr. MILLER OF CALIFORNIA. So that is a yes?

Mr. GIBSON. Yes, that is a mechanical—

Mr. MILLER OF CALIFORNIA. That is what I am trying to get to, those are some concerns we are having here. Does it then follow that the insurer, in order to meet the capital ratios, may have to divest certain assets with high risk-weighting such as those long-term corporate bonds again?

Mr. GIBSON. What we have proposed is a series of risk weights that are—

Mr. MILLER OF CALIFORNIA. And those are weighted higher and so they are going to be considered riskier at the end, they might have to divest themselves of those assets to drop to a better standard.

Mr. GIBSON. Every company chooses its own asset mix.

Mr. MILLER OF CALIFORNIA. I know, but if you are saying that the capital ratios are based on high risk and low risk, if you are then saying long-term corporate bonds are a higher risk, that is going to change your capital ratios.

Mr. GIBSON. Yes. And if you are holding a lot of long-term corporate bonds—

Mr. MILLER OF CALIFORNIA. That is also one of the concerns we are having. Because many of these insurance companies hold those that have proven to be beneficial to them in the long run, but it is going to change their risk and it is going to change the whole matrix within they have to work with. That is where we are trying to get and that is where some of our concerns are. And doesn't this make the proposed rules totally inappropriate for insurers? Think about this, if it is focusing on those, it can't be appropriate for the insurers where they must divest long-term assets to meet long-term commitments they have made to their customers, they bought those for a reason. Wouldn't it be more appropriate for financial

stability for insurers to be able to invest in long-term assets that match up with the long-term liability of life insurance companies?

Mr. GIBSON. In general, the risk weights don't depend on the maturity of the instrument, so a corporate bond would be rated according to the risk of the company that issued it, not the maturity in general.

Mr. MILLER OF CALIFORNIA. But if you are dealing with long-term corporate bonds the maturity is long term.

Mr. GIBSON. Yes.

Mr. MILLER OF CALIFORNIA. And your liability is long term, but the investor is invested in that.

Mr. GIBSON. Right.

Mr. MILLER OF CALIFORNIA. We have a problem. I yield back. Thank you.

Chairwoman CAPITO. The gentleman's time has expired. Mr. Scott for 5 minutes.

Mr. SCOTT. I certainly agree with Mr. Miller, we do have a problem here. And it seems to me that it might be good for us to pause here for a moment to get some clarity on, from you, Mr. French, Mr. Gibson especially, and Mr. Lyons, where do we go going forward now on what I think is the fundamental issue here, and that is one thing we know about Basel III is one size does not fit all. Now, do the three of you agree that we have a problem as affecting this rule regarding our small community regional banks, on requiring them to have this higher capital standard?

Mr. FRENCH. I think that again, when we look back at the last 5 years, we see over 460 bank failures, hundreds of problem banks, and that is a significant issue for the national economy, for many regional and local economies around the country. There is an important policy interest in having a well-capitalized banking system. So I think that is the goal we are trying to achieve.

And as Mr. Gibson said, we have differentiated significantly in terms of the levels of different requirements applied to small and large banks. I think the question we are hearing from the comments is whether we have differentiated enough and that there may be a number of areas, there certainly are a number of areas we are hearing about where they are telling us you need to differentiate more. And we have to be very careful as to how we review those comments and decide how to proceed. So we completely agree.

Mr. SCOTT. Would you say then that one of the directions that you might take would be to disengage the smaller community banks from this Basel III requirement? I did a little studying on the history of this Basel, this has been going on, Basel I started I think under the supervision of the Switzerland bank back in 1988. Basel II comes along to fix what Basel I could not do. Basel III now comes along for this.

My feeling is that it might be smart of us to allow Basel III to see how we can get that to work for what it was essentially created for, and that is the larger banks. It is clear from the discussion of the risk weights complexity that it is going to require another set of thought processes for our smaller community banks. Is that not a way we could go on this?

Mr. FRENCH. The core concept of capital adequacy, having a strong quality of capital and level of capital, we believe that is a relevant concept for any bank and that is something we are trying to achieve. So what we need to do is decide which parts of the proposals are appropriate for community banks, and that includes the mortgages and everything else. We are looking carefully at those.

Mr. SCOTT. And one other area that concerns me is I wonder if you have given any consideration to the overall impact of the Basel III proposals in conjunction with other regulations, such as those mandated by Dodd-Frank and their regulatory and accounting rule standards on credit availability, the cost of credit, and essentially the overall mortgage lending.

Mr. GIBSON. In terms of other Dodd-Frank rulemakings that we are doing, we are certainly looking at the costs and benefits of every rule we propose, and where there are rules that are linked with each other we try to look at those together. We did that with our enhanced prudential standards proposal under Section 165, for example. And certainly in the mortgage area, there are many Dodd-Frank provisions that are all interacting, and we are trying as best we can to look at those together.

Mr. SCOTT. For example, the due diligence with the Consumer Financial Protection Bureau (CFPB), which is finalizing its own due diligence, so we have two due diligence requirements and it makes for some confusion there.

Mr. GIBSON. We are consulting with the CFPB as they roll out some of their Dodd-Frank regulations, and we are working with them on that.

Mr. SCOTT. And finally, Mr. Gonzales, let me get your take on this. What do you feel going forward, is there some value in what I said about disengaging and understanding that if there ever was an example of one size does not fit all, this is certainly it, and that we might need to look at these two sizes of banks differently?

Mr. GONZALES. Absolutely. I think you made a good suggestion, we ought to reconsider and rework these rules. Basel III can move forward. They were never intended to apply to community banks, they are intended for the large internationally active institutions, as you pointed out. So they can go forward on that basis and then we can have a separate dialogue with respect to community banks. We are in total agreement with that.

Mr. SCOTT. Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

Mr. Luetkemeyer for 5 minutes.

Mr. LUETKEMEYER. Thank you, Madam Chairwoman.

I am just kind of curious, Mr. French, Mr. Gibson, Mr. Lyons, do you gentlemen talk with each other with regard to rulemaking between your agencies? Especially in this situation with Basel III, are you guys communicating about your concerns with each other here?

Mr. FRENCH. Yes.

Mr. GIBSON. Yes, we do.

Mr. LUETKEMEYER. You have regular meetings on that?

Mr. GIBSON. Yes, we do.

Mr. LUETKEMEYER. Do you consult with Mr. Gonzales's group at all? Does he have any input with your decision-making process? Because what I hear from him is a whole lot of red flags going off.

Mr. GIBSON. In terms of the rulemaking, it is the Federal agencies that are responsible for the rulemaking. We work a lot with State bank supervisors in the supervision process, and we work closely with them at the—

Mr. LUETKEMEYER. Are you hearing what they are saying about Basel III?

Mr. GIBSON. Yes.

Mr. LUETKEMEYER. Are you going to react to it?

Mr. GIBSON. The comments we have heard from our State bank supervisor colleagues, we have heard those comments, and they are very similar to the comments we have heard from many community bankers. We are taking those very seriously.

Mr. LUETKEMEYER. Okay. Because they are a supervisory agency, as well. They deal with supervising banks as well as you do. So, they have the same concerns and have the oversight that you do, in many respects.

It is kind of curious, I was having—one of my bankers brought this to my attention, with regard to the enforcement of some of the rules that you have. With regard to HMDA exams, one of my bankers did some research. And over the last 2½ years, from during 2010, 2011, to June of 2012, the FDIC in Missouri had over 160 fines that they levied with regard to penalties on HMDA violations. Now, the SEC and the Fed combined had a total of five during that period of time.

Mr. French, can you give me a reason why there is such a disparity?

Mr. FRENCH. My understanding, Congressman, is that we are working on a response to the questions that you have just asked—

Mr. LUETKEMEYER. I realize that, and I appreciate that. Your office said you are going to get me a letter sometime by the end of the week, but I thought while we had you here, it would be a good time to put you on the record. I would like to know what is going on.

Mr. FRENCH. Yes. I will say that we have a separate division of compliance and consumer protection, depositor and consumer protection—

Mr. LUETKEMEYER. The other agencies also have compliance and consumer protection.

Mr. FRENCH. I don't know the answer to your question, so we will have to wait for them to respond to you.

Mr. LUETKEMEYER. That certainly is a red flag to me. And it makes me wonder, when I asked the previous question, if you all worked together with regard to implementation of rules, enforcement of rules, working with the State bank supervisors, whether you actually work together.

How in the world can you all answer that question in a positive fashion when there is that big of a discrepancy between the three of your supervisory agencies on this particular issue? How can that happen? We are not communicating. There is some discrepancy there, and I want to know what it is. So I appreciate your response, and I thank you for that.

With regard to other problems we have discussed today, and we have had a lengthy discussion here with regard to all the different concerns that the individual banks, especially community banks,

have with Basel III. And a lot of it has been brought about by some of the actions that were taken by the big banks back in the early 2000s and up till the 2008 meltdown.

It would seem to me that what is going on is a lot of the new products, a lot of new financial services are outrunning the ability to regulate them. Because we are getting out in front with new policies, new programs, new products that we are having difficulty getting our hands around or arms around to be able to regulate them in a way that can control the risk and minimize its impact to the banking community, the financial industry as a whole.

Is there any thought to trying to pull back on some of those products at all? Or do you think you are going to be able to, by continuing to run, to try and catch up with the new products, that you think you can eventually catch up to them and regulate them?

Mr. Lyons, you haven't answered a question for a while. Let me try to get you in the game here.

Mr. LYONS. I am not quite sure what specific products you are referring to.

Mr. LUETKEMEYER. It deals probably mostly with the big banks, I would imagine, because the smaller banks are probably not in this exotic financial products game.

But it is very concerning to me whenever you have especially the investment banks going off and doing a lot of different things and then you bring them underneath the retail banks, expose the retail banks and the deposit base to FDIC insurance and the too-big-to-fail situation whenever we can't regulate those in a way that is going to minimize the risk.

Is there any thought to trying to do something?

Mr. LYONS. The entire process is part of what we are doing today and talking about is building capital buffers to be able to absorb any loss in those types of products, as well as—

Mr. LUETKEMEYER. Yes, but that is after the fact, sir. What you are saying there is, we are not sure we can regulate these, so the best way to protect ourselves is to put more capital in here. That is covering your rear.

Is there a reason that we can't regulate some of this stuff? Is it beyond our ability?

Mr. LYONS. For those products that we think we can, we permit the use of those products. And for those that we don't, we have not permitted banks to use certain products.

Mr. LUETKEMEYER. Okay. I see my time has expired.

Chairwoman CAPITO. The gentleman's time has expired.

Mr. LUETKEMEYER. Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

Mr. Perlmutter?

Mr. PERLMUTTER. I thank the committee for allowing me to sit in and participate today.

Mr. Gibson, I am reading from a speech that the vice chair, Mr. Hoenig, from our region out in Colorado/Kansas area gave in September. And I don't know if anybody has spoken about this yet, but it was in September of this year. And his comments sort of reflect my feelings about this because I have tried to dive into some of the Basel III rules and assumptions and algorithms. You guys are trying to deal with a panoply of assets and liabilities that are world-

wide and just complex, and I understand the effort that is going into this.

But having said that, there are a couple of paragraphs in his speech I would like to just read, and then I have some questions. It says—and this is a speech that he gave on the 14th of September of this year—"Basel III will not improve outcomes for the largest banks since its complexity reduces rather than enhances capital transparency."

And as I was trying—and I am a lawyer, I did a lot of Chapter 11 bankruptcy work, I looked at a lot of balance sheets, I have dealt with bank dissolutions and a whole variety of things. And your work, as regulators, you have a tough job, especially with different kinds of assets and how you apply risk. But when I look at Basel III, to me, it just adds—it obscures the ability for a regulator or for a stockholder or for somebody else to figure out what a bank is worth and what really is on its balance sheets.

He goes on and says, "Basel III will not improve the condition of small and medium-sized banks. Applying an international capital standard to a community bank is illogical, particularly when models have not supplanted examinations in these banks. To implement Basel III suggests we have solved measurement problems in the global industry that we have not solved. It continues an experiment that has lasted too long."

Now, I appreciate everybody trying to tackle the subject of when is a bank solid and when is it ready to fold. But for us as Members of Congress, for you all as regulators, in my opinion, we need to try to simplify it. Einstein said, "Make everything as simple as possible, but not simpler." This though, in my opinion, goes way too far, that even somebody who took banks apart, like I did as part of my law practice, I can't figure it out. Then, that really allows for the system to be gamed. And that is my fear.

So having given you that editorial comment and asking you to go back and take a look at his speech, I think really reflects where I am coming from with respect to the whole array of rules that you are proposing, or that are being proposed.

Now, let's go into a really tiny, narrow area. And it says—and this is on trust-preferreds. So I was part of this committee when we did Dodd-Frank, and one of the areas that we took a good look at, especially for smaller banks, community banks, was trust-preferred as part of their capital structure.

And under Basel III, the exception that we made in Dodd-Frank to allow for smaller banks to use trust-preferred stock as part of their capital structure seems to be quietly dispensed with. Am I right or wrong?

Mr. Gibson, I will ask you that.

Mr. GIBSON. In the Dodd-Frank Act, trust-preferred was phased out of regulatory capital for all U.S. banks. But—

Mr. PERLMUTTER. But after 2010, right?

Mr. GIBSON. Right.

Mr. PERLMUTTER. So before 2010—and we really, across the Nation, we haven't added a lot of banks over the last 2 years, have we?

Mr. GIBSON. A few, but not too many.

Mr. PERLMUTTER. Okay. So for those banks that existed before 2010 that relied on trust-preferred, they are grandfathered in; am I right?

Mr. GIBSON. No new trust-preferred is allowed to be issued; that is correct.

Mr. PERLMUTTER. But old trust-preferred can exist and be part of the capital?

Mr. GIBSON. There are separate provisions in the Dodd-Frank Act for larger financial institutions above $15 billion where Congress specified a phaseout period, and Congress didn't specify a phaseout period for below $15 billion. In the proposal, we proposed a phaseout period of 10 years.

Mr. PERLMUTTER. Okay. What happens under Basel, under the proposed rules in Basel? So that—

Mr. GIBSON. I was talking about our proposed rule, which is different from—

Mr. PERLMUTTER. Okay, which is different than Dodd-Frank?

Mr. GIBSON. No, no. Our proposed rule is consistent with the Dodd-Frank Act but more aggressive than Basel because of the 3-year phase-out period for trust-preferred under our rule, which is consistent with the Dodd-Frank Act.

Mr. PERLMUTTER. I am sorry. When you say "our rule," is "our rule" the Basel rule, or is "our rule" the Dodd-Frank rule?

Mr. GIBSON. Our proposed joint capital rule would have the phaseout by 2015 for trust-preferred for $15-billion-and-above companies, which is faster than under the international Basel agreement.

Mr. PERLMUTTER. Okay. And I would like to visit with you afterwards about this subject.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

Ms. Hayworth for 5 minutes.

Dr. HAYWORTH. Thank you, Madam Chairwoman.

A question for Mr. Gibson regarding the Collins letter that stated or asserted that bank capital rules with regard to insurers should not supplant capital rules for insurers.

Mr. Gibson, are you viewing things any differently in view of that?

Mr. GIBSON. I haven't seen the letter, but I did read some news articles that quoted from it.

Dr. HAYWORTH. Right.

Mr. GIBSON. It is certainly true that when we made our proposal for holding company capital requirements, the Collins Amendment was an important constraint because it says the bank capital rules have to be a floor for holding company capital rules.

We have certainly gotten a lot of comments from insurance companies and others about alternative ways to interpret what Congress wrote in the Dodd-Frank Act. I look forward to reading the letter that I haven't had time to read yet. But it is one of the issues we are considering very much as we look at the comments going forward.

Dr. HAYWORTH. So we still—and, Mr. McCarty, this obviously goes to your assertions regarding the obligations of holding compa-

nies—the relationship of holding companies and insurers' capital holdings to what holding companies should do in that sphere.

Mr. MCCARTY. Absolutely. To that point, we are very much concerned about the overlaying of the capital requirements of Basel III on a company that primarily does insurance business; only a small part may be subject to a thrift or bank. Again, applying that to that would cause a lot of conflict with already existing regulatory framework and State laws that have proved, I think, very successful throughout the financial crisis.

Dr. HAYWORTH. This could be a rather destabilizing event.

Mr. MCCARTY. Yes, it would be a destabilizing event, and then it could cause a number of dislocations in the marketplace, unintended consequences. For instance, if you have higher capital requirements, a lot of people purchase insurance based upon the brand, the strength of the company. If there is a view that new capital standards is a stronger company, you will have a flight to perceived better-quality products—

Dr. HAYWORTH. Right.

Mr. MCCARTY. —which is, obviously some unintended consequences that could occur.

Dr. HAYWORTH. In listening to this discussion, obviously we are speaking extensively about risk-weighting. That is the crux of the whole thing: what is the level of risk that an institution is undertaking with its holdings and how much—obviously, how much ballast should they have to make sure that the ship stays stable, if you will.

I firmly believe that Peter Wallison's dissent from the FDIC was the most cogent analysis of the 2008 crisis. And one of the underlying factors in that crisis was the fact that the ratings agencies themselves fundamentally, from the standpoint of essentially a layperson like myself, couldn't be trusted.

How does that play into the—how should it play into the decisions that you are making? How should we take what you are doing and say, you know what, if we are going to do these things, then we have to make sure that the ratings certainly of our government bonds actually have validity.

Is that a fair question to ask? I will throw it out to—

Mr. FRENCH. Yes, it is a fair question. I think most importantly for the answer is that the Dodd-Frank Act requires the agencies to remove references to credit ratings from all of our regulations. So part of what this proposal does is implement that so that instead of using external credit ratings of Moody's or Standard & Poor's or whatever, there are various alternative approaches. So, essentially, we have moved away from that in these proposals.

Dr. HAYWORTH. That sounds reassuring.

Thank you so much, members of the panel.

And, Madam Chairwoman, I yield back.

Chairwoman CAPITO. Thank you.

Mr. Lynch for 5 minutes.

Mr. LYNCH. Thank you, Madam Chairwoman.

Mr. Lyons and Mr. French, this is particularly addressed to you. I recently have had extensive opportunities to sit with my local chambers of commerce, populated significantly by community banks and leaders of community banks.

And, Mr. Lyons, in your remarks you posed a somewhat rhetorical question: Why should community banks be treated this way under Basel III? Why should these limitations, the enhanced capital requirements, be applied to them, given the fact that they really weren't at the root of the financial crisis? For the most part, they know their customer. They did not engage in these wildly complex derivatives. And, I got an earful from my bankers about the rules coming out.

I did hear from each of you that you acknowledged the difficulty or the challenges in applying some of this to both insurance companies and also to community banks. So I like what I am hearing, in a way, that you are sensitive to the issues.

But to answer your own question, why are we applying all of this to community banks?

Mr. LYONS. Thank you, Congressman.

I think it is important to point out that, while they may not have caused the crisis, they did suffer substantial damage because of the crisis in terms of failures. We had well over 400 failures. And, as Mr. French said earlier, a large number of banks are still in troubled condition.

The stronger banks that did survive were those that had higher capital. And we felt it was appropriate to try and strengthen the quality and quantity of capital for individual banks and within the system overall so that in the next crisis, they can survive and continue to serve their customers and communities.

Mr. LYNCH. The longer on-ramp, is that something that has been accepted, at least among yourselves as regulators, for the ability of the community banks that may not have the staff and the compliance mechanisms to absorb all of this? Is that something that has been accepted by your group or with regulators in general?

Mr. LYONS. I think, as Mr. Gibson said earlier, we did do an impact analysis. Most banks already achieved that capital level. The impact analysis also looked at the financial cost to an institution to be able to implement the new regs. And there is a concern around the cost burden to the institutions, especially up front when they have to implement new systems and controls to implement the requirements.

So we are taking a close look at those analyses, and we will do further analysis as we move forward. But I assure you, we are trying to strike the right balance between achieving appropriate capital levels and not overburdening community banks.

Mr. LYNCH. You mentioned that about 90 percent of the community banks already satisfy what you think would be the—I am sorry, Mr. Gonzales, would you like to respond?

Mr. GONZALES. Yes, I was just going to address that 90 percent issue.

We would agree that a large number of community banks would be able to meet the minimum standards today, a snapshot today. But the real question is, where do these rules put community banks going forward? That is the real question.

And, just a couple of examples. Are we going to accept the volatility of the capital with respect to movements in interest rates? And with the risk of weighted standards, we are basically telling institutions whether you have good operating procedures or not, we

don't want you in these areas, commercial real estate and certain mortgage products.

So that is very concerning. It is a one-size-fits-all approach.

Mr. LYNCH. Yes. That is what I am hearing.

Let me ask, the general number is 90 percent of the community banks will meet the new capital requirements already. That remaining 10 percent, are we looking at banks that are particularly large within the community bank population, or is it just random?

Mr. LYONS. Our analysis showed that it is generally the smaller banks, a small population of smaller banks that would not achieve it immediately. That is why we implemented the transition periods. And our feeling is that over the transition period, those banks would be able to accrete and achieve the minimum capital levels.

Mr. LYNCH. Okay. I see I am running short on my time here. I would just, in closing, ask you to be very sensitive to the concerns, as you say, valid concerns, raised by our community banks. They are doing the lending right now in many of our communities, and we rely on them very heavily right now to keep the economy going in the right direction. So I would just ask you to be very sensitive to the concerns that they have raised.

Thank you, I yield back.

Chairwoman CAPITO. Thank you.

Mr. Duffy for 5 minutes.

Mr. DUFFY OF WISCONSIN. Thank you, Madam Chairwoman.

As I mentioned in my opening statement, I come from rural Wisconsin. We have a lot of small community banks, and a lot of credit unions that we are not necessarily talking about today, but those are the folks who serve the financial needs of my community, getting dollars out to our families, and our small businesses that are the economic drivers of our community.

Many of the comments that you have heard today and concern you have heard today, I, too, have heard that same concern from my small financial institutions, about how Basel III's implementation will affect their ability to be successful moving forward.

Have you all considered the overlay of all the proposed rulemakings and its impact on the consolidation of community banks across the country?

Because I keep hearing about all the new rules, all the new regulations, and the need for small banks to continue to consolidate. And one of the benefits we have is you can get decisions in your community. Say, you are in Medford, Wisconsin. Your banker there can make a decision for you, instead of having to go to Minneapolis or Chicago or Milwaukee, and have a regional bank make those calls for you.

Are you concerned about that consolidation?

Mr. FRENCH. If the outcome of the rules was to drive significant consolidation of community banking, we would be very concerned. We recognize the important role that community banks play in local communities, and we do not want to finalize rules that will put such a degree of compliance cost on them or change the economics of what they are doing so significantly that they cannot fulfill those roles and are forced to consolidate.

So we have heard—as I said earlier, we have met with community bank groups around the country, our acting chairman as well

as the staff, and we host them here in Washington. We had a good discussion of these issues at our Community Bank Advisory Committee a couple of weeks ago. So we are very focused on these comments, I can assure you.

Mr. DUFFY OF WISCONSIN. Good.

And when the Basel Committee met, you have a group of people who usually come from countries that have larger banking institutions. They don't have a community bank structure like America does; they have a larger bank structure in the countries that all met on Basel. Is that correct, or is that fair to say?

Mr. GIBSON. For many of the countries, yes.

Mr. DUFFY OF WISCONSIN. For many, yes, right.

And so as we look at this rule that has come out of Basel and Basel III, and now you have proposed it here—my guys are concerned that they didn't really have an effective voice because we were concerned about the megabanks and there wasn't really this concern about its impact on the small community banks.

So you have a rule that is being proposed that had a lot of folks sitting around a table who were concerned about the larger institutions, and the voice of the smaller institutions wasn't considered. And if it had, there might have been some different proposals made for the community banks, or they, as they had hoped, would have been excluded.

Mr. GIBSON. When we discuss in the Basel Committee, we agree to apply those Basel agreements to our internationally active banks, which is a very small number of banks. We have proposed something that very closely tracks the Basel agreement for the largest banks. But what we have proposed for smaller banks is different from what the Basel Committee agreed. We have tailored it to the specific circumstances of our community banks and our banking model.

Now, we have gotten a lot of comments that we need to do more tailoring, and we are looking at those. But we have never applied Basel agreements to all—or we are not proposing to apply Basel agreements to all U.S. banks.

Mr. DUFFY OF WISCONSIN. I want to ask a quick question on the available-for-sale securities and how frequently the proposal is that they will be required to do that calculation. Is it once a day? It is once a month, a quarter? How frequently do they have to make that calculation?

Mr. FRENCH. For purposes of their quarterly financial reports to the regulators, the proposal would be that they would include in their regulatory capital any unrealized gains or losses in their available-for-sale debt securities, which is a change, a proposed change, from current practice, where they do not include that in their regulatory capital.

The safety and soundness argument for that is that if they are forced to sell these securities in a dire scenario or a stress scenario, they are going to have to take those losses, and that really is what reflects their capital strength.

The counterargument is that they hold these things for liquidity. It is going to introduce significant volatility to regulatory capital from their perspective and complicate their management of interest-rate risk, legal lending limits, and other things.

So, we have to look at those comments very seriously and relative to the underlying objective.

Mr. DUFFY OF WISCONSIN. And I see my time has expired. I yield back. Thank you.

Chairwoman CAPITO. Mr. Sherman for 5 minutes.

Mr. SHERMAN. Mr. French, you talk about, in effect, marking to market the available-for-sale securities. Some banks will want to strengthen their position by identifying their winning securities that have gone up in value as available for sale and those that would be marked down as not available for sale.

How strict is the definition? And what is the consequence of declaring, this security is available for sale, that security is not available for sale?

Mr. FRENCH. I think in the proposal they would have to recognize all of the unrealized gains and losses on all the available-for-sale securities. You raised the issue—

Mr. SHERMAN. But what is the definition of an available-for-sale security? We are not going to sell it anytime soon.

Mr. FRENCH. You raised the issue of gaming it and moving it to the held-to-maturity. That is an important consideration that we have to think about, I think, as we decide.

Mr. SHERMAN. Do the regulations define "available for sale?" And can that just be in the mind of the holder?

Mr. FRENCH. It is a defined term in accounting, so, yes.

Mr. SHERMAN. Well, perhaps you could get back to me with something for the record that is more definitive than that, and not so much dealing with gaming the system. It is just, if you have an opportunity to easily decide whether or not something is available for sale or not being intended for sale, you might happen to notice what effect that would have.

Mr. Gibson, Basel III standards provide favorable supervisorial treatment for short-term assets and unfavorable treatment for long-term assets held by insurers. Long-term assets would include corporate bonds. Banks tend to deal more short-term. Insurers—I have a life insurance policy. I hope that is a very long-term obligation of my insurance company.

If the Federal Reserve compels insurers to remake their balance sheets in compliance with Basel III standards, what is the impact on insurers? Will that push them out of long-term assets into short-term assets? And is that contrary to the sound economic principle that if you have a long-term liability, which I hope my life is, that you match that with a long-term asset?

Mr. GIBSON. For banks and bank holding companies, we have other regulatory requirements on liquidity that look at the kind of maturity mismatch you are talking about.

For capital, we are looking at the potential for losses, so we look mostly at the credit risk of the asset. If it is a risky company, the capital charge would be higher. If it is a less risky bond, the capital charge would be lower.

Mr. SHERMAN. But in terms of an insurance company, if you have a long-term asset, yes, its market value will be affected more dramatically by swings in interest rates no matter how creditworthy the issuer, but the offsetting liability to those who are insured is also long term.

Would you be treating insurance companies the same as banks when you are looking at how to unfavorably treat long-term assets?

Mr. GIBSON. For the purposes of risk weights based on credit risk, we have proposed the same risk weights. This proposal doesn't deal with liquidity risk, but it would be very different for an insurance company than for a bank.

Mr. SHERMAN. So you are going to be dealing with—I know that we have a representative from those who currently regulate insurance companies. Do we need another level of regulation, or have the States done a good enough job?

Mr. MCCARTY. Certainly, if you look at the evidence during the financial crisis, we think the States fared very well in the current regulatory system. But it is very fundamentally different than banking. As you were pointing out, the matching of the assets and liabilities is very critical. There is a reason why you don't have a run on an insurance company, because of the structural difference in how products are regulated.

We look at the entity, separate and corporate, individual insurer entity as opposed to one consolidated view of it. And we think it is important to keep assets and the policyholder's money there available to pay claims.

Mr. SHERMAN. I want to commend the State regulators. Those regulated insurance subsidiaries did very well in surviving the crisis. And it is interesting that AIG had both regulated and unregulated operations. That which was regulated by the States might be profitable enough to bail out that portion of AIG that I think in a perfect world would have been regulated by insurance regulators but was not.

I think my time has expired.

Chairwoman CAPITO. Mr. Pearce for 5 minutes.

Mr. PEARCE. Thank you, Madam Chairwoman.

The comments by Ms. Waters and Mrs. Maloney I think headed in the direction that my interest lies, and that is sort of a fascination with community banks from your perspective.

When I look at the capital requirements, I see a very complex system. In other words, you really have generated a lot of parameters. And I kind of wonder if the same parameters were used in evaluating the failures. I have heard 2 or 3 of you talk about the 460 failures, and you give a lot of attention to real estate. Did you slice and dice the real estate as much as you sliced and diced the risk that you are going to have community bankers hold?

In other words, I suspect that there were greater failures per capita maybe in Florida or Las Vegas, Nevada, than, say, Tucumcari, New Mexico. I suspect that we didn't have a lot of out-of-State people coming in. I don't think people were rolling real estate.

Did you do any analysis of the actual failures themselves before you said to community bankers, you are going to hold these kinds of assets? Because you are shutting down the future of small States. You are limiting it. And I am asking, does your analysis of the failures go as deep and as finely sliced as your analysis of what you are going to have the banks hold?

Mr. French, you can start, if you would like.

Mr. FRENCH. Sure.

Every time we have a failure over a certain size, we do a material loss review. Our Inspector General does that. And, typically, the profile of the failed banks in the last 5 years was—the most frequent profile was a lot of construction lending and funded by broker deposits, would be the typical failed bank. So that was the kind of a bank that got hit.

Mr. PEARCE. And then did—if I can interrupt right at that point. So a lot of construction loans. Now, then, were there a lot of construction loans in certain areas versus other areas? How many banks in New Mexico failed over construction loans, for instance? And I don't expect you to answer that. But I suspect if you look at the 460 bank failures, if you had a map of the United States and sticking pins in the places where the banks failed, I suspect they are going to be clustered in locations. And yet, you are painting with the same broad brush across the entire country, saying that you are not doing one-size-fits-all.

So my question is not so much about what caused them to fail. My question is about your process. Did it get as infinitely evaluative as you did on requiring capital for community banks? That is my question.

So, Mr. French, yes or no? Have you sliced and diced it in that—

Mr. FRENCH. I don't believe we have sliced and diced the failed banks using the metrics in the—

Mr. PEARCE. No, that is not my question. My question is, if you put those pins in the map, did you say, there are some places that inherently took advantage of the system and some places did not? I suspect we could have a different measurement criteria for Tucumcari, New Mexico, or Alamogordo, New Mexico, as we do in maybe one of the high resort areas of Florida. Did you slice and dice it that finely?

Mr. FRENCH. I don't think we would see many pins in the map in New Mexico, and I think—

Mr. PEARCE. We have the same requirements as if we were located right there in one of the high-traffic areas.

Mr. FRENCH. And one of the frequent themes in the comment letters is exactly what you are suggesting, that we have painted sort of too broad a brush with the—

Mr. PEARCE. Do you know how miserable you all make my life when you do this broad, random stuff?

And one other thing. My time is rolling down rapidly, and I am probably only going to get to make the point. Did you slice and dice by size? In other words, did you make sure that most of the regulatory requirement fell on those who, by percent, failed in the greatest percentages? If I were to look at Wall Street banks—there are very few of them—the failure rate was fairly great as a percent.

And when I do your percentages, you are rolling the 460 over and over and over again as if that is going to convince us. But when I divide 460 by 7,000 small community banks, I get a failure rate in the 5 to 6 percent range. And I wonder if you put that metric into your measurement before you went out and just put these rules out that frightened the daylights out of not just the community bankers but the small States themselves, who see capital drying up because of what you have done just proposing your rules.

And I think before you put these complex matrices together for community banks to put out what they are going to have to capitalize, you ought to do a better, more infinite study on what caused the failures and where they occurred than what have you done.

I yield back, since my time is gone. Thank you.

Chairwoman CAPITO. The gentleman yields back.

Mr. Stivers?

Mr. STIVERS. Thank you, Madam Chairwoman.

I would like to ask unanimous consent to enter two things into the record: a letter from Senator Collins; and a letter on behalf of regional banks and some of the challenges that they face.

Chairwoman CAPITO. Without objection, it is so ordered.

Mr. STIVERS. Thank you.

My first question is for Mr. Gibson.

Mr. Gibson, do you believe Dodd-Frank requires you to apply capital rules identically to insurance companies as banks?

Mr. GIBSON. No. We only apply capital requirements to depository institution holding companies, which includes ones that happen to own an insurance company. We have tailored in the proposal—

Mr. STIVERS. I guess that is—I am sorry if I was not specific enough, but—

Mr. GIBSON. Okay. Go ahead.

Mr. STIVERS. —where there are insurance company assets inside a bank holding company, do you believe that it requires identical capital to as if that was a bank asset?

Mr. GIBSON. No. And we tailored the proposed requirements to insurance businesses in several areas—for example, separate accounts and policy loans. However, we are constrained by the Collins Amendment, which sets a floor on holding company capital requirements equal to what the bank capital requirements are.

Mr. STIVERS. Well, I have a letter from Senator Collins to your boss that says she believes they can actually, within the constraints of her amendment, sort of work with the standards and work with folks like NAIC to make sure that the standards are appropriate for insurance companies.

So I would ask you to take a look at that. I submitted it for the record.

My second question for you is, what credit do you think State-based regulation and State-based risk capital should be given to insurance companies because they have State-based risk capital? And when those laws conflict, do you think you actually supersede the State laws? Because I don't see that in Dodd-Frank.

Mr. GIBSON. No. What we do is, we are setting a capital requirement at the holding company level. And at the level of individual operating companies, whether it is a bank or an insurance company, they are separate capital requirements by the functional regulators.

Specifically, with respect to insurance companies, they have capital requirements set by their insurance regulator on insurance underwriting risk, for example. We don't set any capital requirement on that. We just take the number that comes out of the State insurance regulatory system and we just plug that number into ours.

Mr. STIVERS. And there is going to be additional systems cost to folks who happen to own insurance assets that they don't have today because they currently calculate their capital based on the State-by-State approach. Did you calculate any of that into your costs when you did your cost-benefit analysis?

Mr. GIBSON. We generally consider the impact of what we have proposed. But we have heard comments, especially from depository institution holding companies that own insurance companies, that they would need more time to adjust to the changes because the changes would be greater for them. They were not subject to this kind of consolidated regulation before.

Mr. STIVERS. Correct. And I didn't see anything that allows you to do that. Are you working hard to make that happen? That is a yes-or-no question, with my limited time.

Mr. GIBSON. We have heard those comments, and we are working to incorporate them as we go forward.

Mr. STIVERS. Great.

My next question is for Mr. Gibson and Mr. Lyons. Somebody before said it is really activities of the bank, not the size, that determines the risk. And I am really worried about mis-ascribing the cost of risk, especially associated with mortgages and home equity lines of credit, especially with regard to the Qualified Mortgage, which has yet to be completely defined.

Now, that has come up a little bit before, but can you talk about what you are going to do to make sure that we don't mis-ascribe risk? Because if we do, it is going to drive up the cost of credit and limit credit availability.

Mr. LYONS. Congressman, we attempted to calibrate risk based on the performance of those assets through the crisis. We have received comments from many, many banks and institutions that we need to take a look at, a second look at that, and we will as we go through the process. But we attempted to calibrate the risk based on the performance of those assets through the crisis.

Mr. STIVERS. Is there any way that you can finalize this before the QM definition is defined? Because I don't think you—if you really are going to do that, how can you finalize this rule before the QM rule is finalized?

Mr. LYONS. That is a good point. In the proposal, there are two categories of mortgages, category 1 and category 2. Category 1 closely resembles what we think will come out of QM. But we are working very, very aggressively to review all comments and come up with a final proposal.

Mr. STIVERS. And that kind of brings me back to—and I only have 10 seconds—the problem with this requirement is it is so complex and granular, that it has interplay with other regulations that are only in proposal stage. And, it could be very problematic, very difficult to implement, and, in fact, contradict with or just not give credit to some of the other regulations that other regulators are spending a lot of time and effort to get right.

So I would hope you would be mindful of that as you proceed on this course.

Chairwoman CAPITO. Thank you.

I want to thank the gentlemen.

Mr. STIVERS. Thank you. I yield back.

Chairwoman CAPITO. Thank you.

That concludes the first panel.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

I would also, before I dismiss them, like to enter these statements for the record: Mid-Size Bank Coalition of America; Consumer Bankers Association; American Council of Life Insurers; American Insurance Association; America's Mutual Banks; Mortgage Bankers Association; Council of Federal Home Loan Banks; Financial Services Roundtable; MCAM; and the National Association of Insurance Commissioners.

Mr. PERLMUTTER. Madam Chairwoman?

Chairwoman CAPITO. Yes.

Mr. PERLMUTTER. I would like to enter into the record the speech by Tom Hoenig of September 14, 2012, that I read from.

Chairwoman CAPITO. Without objection, the speech from Thomas Hoenig will be inserted into the record.

Mr. PERLMUTTER. Thank you.

Chairwoman CAPITO. I want to thank the gentlemen on the first panel. I appreciate your very forthright testimony.

We will switch out, and I might stand up and take a little break myself. So we will start back in about 4 or 5 minutes.

[recess]

Chairwoman BIGGERT [presiding]. I think we will start. We are still missing one witness, but let's get started so that—I know you have all been waiting a long time. That was a long time for the first panel.

I am now going to introduce the second panel. First of all, we have Professor Anat Admati, George G.C. Parker Professor of Finance and Economics, Graduate School of Business at Stanford University.

Second, we have Mr. Terrence Duffy, executive chairman and president, CME Group Incorporated. It is very nice to see you. Mr. Duffy has been one of my constituents for 14 years. And I have enjoyed working with you.

Third, Mr. James M. Garnett, Jr., head of risk architecture at Citi; followed by Mr. Marc Jarsulic, chief economist, Better Markets, Inc.; Mr. William A. Loving, president and chief executive officer, Pendleton Community Bank, on behalf of the Independent Community Bankers of America; Mr. Daniel Poston, chief financial officer, Fifth Third Bancorp, on behalf of the American Bankers Association; Mr. Paul Smith, senior vice president and chief financial officer, State Farm Mutual Automobile Insurance Company; and Ms. Virginia Wilson, executive vice president and chief financial officer, TIAA–CREF.

Thank you all for being here.

And we will start with the first witness. Professor Admati, you are recognized for 5 minutes.

STATEMENT OF ANAT R. ADMATI, GEORGE G.C. PARKER PROFESSOR OF FINANCE AND ECONOMICS, GRADUATE SCHOOL OF BUSINESS, STANFORD UNIVERSITY

Ms. ADMATI. Thank you. I very much appreciate being here today. I have spent a lot of my time thinking precisely on the issue of capital, and I have some materials. I have not submitted comments for this one because I was busy writing a book on the subject.

The first thing I want to refer to is the question that was asked in the invitation letter, which asked about how capitalized the U.S. institutions are. And, specifically, it asked how their capital reserves compare to the years prior to the crisis.

The term "capital reserve" leads me to stop right here, as well as what I have been hearing in the last 2 hours, to just make a very important clarification about what we are talking about. The use of the term "capital reserves" is very, very confusing, as is the language being used. The term "reserves" is like a rainy-day fund. It is cash set aside for some emergencies. And you could say the banks hold reserves. A certain fraction of their assets are actually in cash or in deposits with the central banks.

But the problem is that unless reserves are, like, 100 percent or very, very, very high, they don't solve the following problem. And the problem is, when the banks make loans, how are they going to be able to absorb those losses without becoming distressed? That is where capital comes in. So the word "capital" actually refers basically to unborrowed funding. It has nothing to do with what the banks actually hold.

So banks actually do not hold this capital, and there is nothing stopping them from lending capital. Because in the rest of the world, in the rest of the economy, the word "capital" is actually not used in that way. The word that is used is "equity."

And down the street from me in California there is a company called Apple. And we do not say that Apple holds 100 percent capital. But Apple actually does not borrow, and yet it invests a lot. So there is nothing about capital that actually stops lending, nothing about it. Lending will happen if banks want it.

And the only issue about lending is who bears the losses when that happens. Is it the safety net, or is it the banks themselves and their shareholders? If they lose on any investments, can they still function, or do they become so distressed that we see a problem? So the issue is the extent of borrowing that banks do.

Banks are among the most indebted corporations in the economy. Nobody in the economy borrows as much. There is no healthy company in the economy that operates with a single-digit amount of equity. And so, banks might tell you that is their business, but that is false. It is not their business to be as highly leveraged. In fact, when they are so highly leveraged, they do worse for the economy because the stress or highly indebted entities do not make good investment decisions.

The key for banking stability is the banks have sufficient funding with equity so they can withstand losses without getting the stress, and so they worry about the downside of their investments more than they currently do. The safety net of banking has increased and expanded to a degree that people forget that they are actually

corporations who can own their decisions on the upside and on the downside.

We do regulate them, and we do not regulate the other companies in the economy, and yet they do not borrow as much. They could, but they don't. Why do banks love so much borrowing? I have written extensively about this, and I won't talk about it here. We do regulate the amount of borrowing because when they get distressed, we all suffer. So that is important.

How much equity should they have? I side with—my benchmark is pre-safety-net, just like Mr. Hoenig, and it is certainly not in the single digits relative to total assets. That is the amount of equity that they should have. There is absolutely nothing at all that stops banks from having 20 or 25 percent equity. They will have to transition there, but that is the way they would be healthier and serve the economy better. There is no increase in their funding cost except for the fact that they own more of their downsides and they are less able to use tax subsidies and borrowing than other people who don't use as much as they do.

The Basel is risk-calibrated, and this risk calibration actually creates distortions in lending. Banks lend too much to mortgage, and now we want to correct that, but next they might lend too much. So municipalities which have low-risk rates in Europe, they lend too much to governments and they take the governments and themselves down. That is very unhealthy. So the risk weights can be highly destructive to lending.

What we need banks to do is lend to businesses. The risk weights actually discourage that. Banks would lend if we give them the opportunities to lend and not expect them to do so. The current regulation is made that way, and it is greatly insufficient.

One comment on whether it should be one-size-fits-all, definitely not. But the biggest institutions definitely need more capital requirements, but the one thing that all regulators should do—and if they are not here, I have certainly tried to say this to them. The one thing that must be done right away on the biggest institutions is to stop them from paying out to their equity holders right now and for the foreseeable future. There is absolutely no reason that a large institution should pay to its equity holders, to its shareholders, instead of lending the money, paying down their debts. Their debts are debts that they chose to take, overfunding with equity. When they pay out, the equity is depleted, and the economy is harmed.

That is a failure of the regulation, repeating failures from before the crisis, where half of the amount that TARP ended up having to put into the banks was the amount that was paid in the years 2007–2008 out to shareholders, disproportionately to bank managers. This industry should be brought into the world of real economic costs and benefits.

Thank you.

[The prepared statement of Professor Admati can be found on page 88 of the appendix.]

Chairwoman BIGGERT. Thank you.

I now recognize Mr. Terrence Duffy for 5 minutes.

STATEMENT OF TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN AND PRESIDENT, CME GROUP INC.

Mr. TERRENCE DUFFY. As a former trader, I actually didn't need a microphone. I was going to be able to yell just fine.

But let me thank you, Madam Chairwoman and members of the subcommittees, for allowing me to testify today. And, Madam Chairwoman, let me also thank you for all of your service to your district and to our district, for your service and your leadership. You did a wonderful job, and we are going to miss you. So thank you very much.

CME Group applauds the Federal Reserve Board, the FDIC, and the Office of the Comptroller of the Currency for deferring the capital rules, and implementing the Basel III Interim Capital Framework.

Both Dodd-Frank and the G-20 mandates aim to reduce systemic risk and increase the transparency. Our concern is that Basel III's one-size-fits-all rules for capital charges based on the risk of cleared derivatives is at odds with these objectives.

The Basel framework treats all cleared derivatives as if they require a margin to cover a 5-day period of risk. This means that highly liquid derivative contracts that trade by means of central limit order book that can be easily and quickly liquidated without substantial risk are put in the same category as cleared OTC contracts that are not usually liquidated or traded transparently.

Clearinghouses recognize the difference between these two products. They require margin levels based on timeframes that are justified by the actual risk inherent in liquidating the positions. In the United States, this means 1 or 2 days for futures, and 5 days for less liquid cleared swaps.

If capital charges are not based on properly measured risk, it could encourage the use of higher-risk instruments. This is inconsistent with both Dodd-Frank and the G-20 policy goal to reduce risks in derivative trading by moving from opaque markets to transparent markets.

Clearinghouses properly set margins for liquid derivatives to cover 1-day risk. If banking regulators impose a capital charge based on a 5-day, banks will be burdened with unwarranted capital requirements. This cost will be passed down to the customers trading liquid products in the form of higher collateral or higher fees, once again contrary to the Dodd-Frank Act.

This could distort customers' product choices. Customers may move away from trading liquid exchange-traded derivatives. There is the potential that central limit order book exchange-traded products could be more expensive. The last thing we want to do is drive customers back into an opaque OTC market because of a one-size-fits-all margin period.

Basel III's one-size-fits-all margin period is also inconsistent with the international clearinghouse standards. These standards recognize that margin levels and risk periods should correspond to risk and liquidity profiles: as I said earlier, 1 to 2 days for futures; 5 days for OTC cleared swaps; and then, of course, 10 days for uncleared swaps.

Liquid derivatives traded via a central limit order book and cleared through a clearinghouse offer complete transparency. They

trade in deep liquid market. The turnover is 10 times more frequent than OTC swaps. Those characteristics permit rapid offset and liquidation in the event of an emergency.

There is no risk management benefit to the banks or the system by imposing capital charges beyond the clearing level margin established by these liquid contracts. We have expressed these concerns in written comments to the Fed, the FDIC, and the OCC. We have also had discussions with the Fed staff. In addition, we have submitted two letters to the Basel Committee.

The agencies' capital rules should be amended to eliminate the addition of 4 days' capital on top of a 1-day margin for exchange-traded derivatives. This should be replaced with an approach consistent with the current standards. These standards recognize that margin periods will differ based on the liquidity, transparency, and other risk-reducing characteristics of each product.

I want to thank you for the opportunity to testify before you today.

[The prepared statement of Mr. Terrence Duffy can be found on page 126 of the appendix.]

Chairwoman BIGGERT. Thank you, Mr. Duffy.

Mr. Garnett, you are recognized for 5 minutes.

STATEMENT OF JAMES M. GARNETT, JR., HEAD OF RISK ARCHITECTURE, CITI

Mr. GARNETT. Good afternoon, members of the subcommittees. My name is Jim Garnett, and I am the head of risk architecture for Citigroup. In that capacity, I am responsible for implementing the Basel III capital rules for Citi within the United States and throughout the 160 countries and jurisdictions where Citi does business around the globe.

Citi broadly supports the goals of Basel III capital rules proposed by the U.S. banking regulators. As a global bank, Citi has long supported risk-based capital standards along with heightened liquidity standards. We recognize the importance of capital to serve as a buffer against changing market and economic conditions. Aligning capital with economic risks ensures that adequate capital exists to cover risks and avoid excess capital, which can unnecessarily constrain lending and investment activities that support the real economy.

There are, however, certain features of the proposed rules that deserve refinement in order to avoid unintended negative consequences.

First, cumulative capital levels will unnecessarily constrict credit for all but the Nation's most creditworthy borrowers. Notably, small-business owners will be adversely affected in the form of higher credit costs and constrained credit availability, particularly because small businesses do not have direct access to the capital markets.

To help avoid capital standards that divide consumers, we support the industry's call for a quantitative impact study of the proposed rules. Such a study would enable Congress, the Federal banking regulators, and others to better understand the impact of the proposed rules and, if appropriate, make adjustments that avoid an unintended contraction in credit to customers.

Second, the elimination of the filter for the accumulated other comprehensive income in calculating Tier 1 common equity will negatively impact the ability of banking organizations to extend new credit, thereby reducing investments in U.S. Treasuries, agency debentures, and mortgage-backed securities.

A better solution would be to continue to exclude unrealized gains and losses in Basel III Tier 1 common capital for available-for-sale securities of only the most creditworthy and liquid issuers. This approach would create consistency between the regulatory capital treatment of securities and the regulatory capital and accounting treatment of the deposit liabilities they are largely hedging. Further, it would reduce the negative consequences caused by volatility in regulatory capital levels.

Third, we are concerned about the apparent lack of uniform application of capital and other supervisory standards within the United States and globally. An unlevel Basel playing field across national jurisdictions can arise from two different sources. First, banking supervisors in different countries may apply different standards when approving internal models or approving internally calculated risk parameters.

Second, if the Basel rules are adopted and implemented uniformly, a given rule can have a disparate impact across national jurisdictions because of differences in market structures and associated accounting standards across countries. Thus, U.S. international banking regulators need to ensure that the Basel III rules are applied consistently and uniformly. Deviations in risk-weighing should not be allowed.

Finally, we believe the capital rules should be tailored to different types and sizes of banks. Community banks are justifiably concerned about the compliance costs imposed by Basel III, and Citi supports a simpler set of risk-based rules for these institutions. The Federal banking regulators should reconsider the application of Basel III through traditional community banks that do not have complex balance sheets and permit such institutions to continue to comply with Basel I or some other simplified risk-based capital regime.

In closing, I would like to note that Citi today is one of the best-capitalized banks in the world. We support strong capital requirements as one of the critical pillars of a safe, sound, and effective financial system. We have added over $140 billion in new capital to our capital base. Our capital strength is more than 5 times higher than it was during the crisis. Although the Basel III capital requirements do not fully become effective until January 2, 2019, Citi is well under way toward complying with them, both the baselines and the surcharges. We are in a position to put our financial strength to work for our clients during challenging and uncertain economic times, and we are doing so.

Thank you again for the opportunity to discuss these important rules, and I am happy to answer any questions you may have.

[The prepared statement of Mr. Garnett can be found on page 168 of the appendix.]

Chairwoman BIGGERT. Thank you very much.

Mr. Jarsulic—am I pronouncing that correctly?

Mr. JARSULIC. Yes, you are.

Chairwoman BIGGERT. You are recognized for 5 minutes.

STATEMENT OF MARC JARSULIC, CHIEF ECONOMIST, BETTER MARKETS, INC.

Mr. JARSULIC. Good afternoon, Chairwoman Biggert, Ranking Member Maloney, and members of the subcommittees. Thank you for the invitation to Better Markets to testify today.

I will note that I am summarizing written testimony that I have submitted to the committee, and I will restrict my comments to two issues: the adequacy of proposed capital requirements generally; and the application of these requirements to community banks.

Let me begin by observing that the financial crisis revealed two important weaknesses of the U.S. banking system.

The first weakness is that U.S. banks use far too much debt and far too little equity to finance their positions. High leverage makes them vulnerable to asset price declines and creditor runs. This is very clear from the data. As detailed in my written testimony, highly leveraged banks such as Washington Mutual, Wachovia, Citigroup, and Bank of America all went through similar scenarios. As the crisis developed and they charged off loans and wrote down assets, markets doubted that they were solvent. They either lost access to the capital markets and failed or were rescued by the injection of government equity and other crisis support.

Their losses, or the sum of their losses plus government equity injections, were between 7 and 11½ percent of tangible assets. The failure or near failure of these and other important banks clearly indicate that banks require common equity of at least 20 to 25 percent of tangible assets to survive financial crises of the severity that we have just witnessed. They require that much equity to absorb large losses and remain viable.

The second weakness is that the broker-dealers operated by large banks are highly exposed to the risk of very rapid counterparty runs. Broker-dealer trading is heavily reliant on repo financing, which can be highly unstable. In early 2008, there was a general run on repo as firms and asset classes became suspect even for overnight loans. By the end of the year, the outstanding repo held by primary dealers contracted from a peak value of $4.6 trillion to $2.4 trillion.

It is also the case that the broker-dealers with large over-the-counter derivatives books are subject to rapid runs during which their counterparties novate contracts, close out contracts, or make margin calls. Runs of this kind materialized during the financial crisis at Bear Stearns and Lehman Brothers, contributing to the collapse of those firms.

Let me next observe that the proposed capital rules do not adequately address either of these two weaknesses. The proposed capital rules do not require banks to use nearly enough equity finance. For example, the proposed rules require banks to have common equity equal to 4 percent of on-balance-sheet assets. But the evidence clearly indicates that banks require common equity equal to at least 20 to 25 percent of their tangible assets to survive financial crises of the sort we have just witnessed.

In addition, the proposed rules do not require banks to self-insure against the run risk posed by over-the-counter derivatives and

repo borrowing. The proposed rules allow banks to calculate repo exposures net of collateral used to borrow and to calculate derivatives exposures net of counterparty exposures. These net calculations do not reflect the fact that runs on repo finance will mean a loss of gross repo financing or that the run on over-the-counter derivatives is related to gross exposure to the weakened dealer. Instead, equity requirements should rise as trading operations increase their gross repo borrowing or gross derivatives exposures. This would force banks to self-insure against runs.

Finally, let me observe that while it may prove useful to make some adjustments to the proposed capital requirements for community banks, those adjustments should be restricted to a properly defined set of banks. The banking agencies have indicated that the capital rules may need some changes to account for issues that are specific to community banks. Some real changes discussed in my written testimony may help preserve the supply of credit to households without significantly increasing the risk to the overall financial system.

However, these changes should be restricted to genuine community banks. Researchers often use an asset threshold of $1 billion as a proxy to identify community banks. If that threshold were raised to $10 million, it would mean, with the exception of some small banks and multiple bank holding companies, 98 percent of all individual banks would be considered community banks. Such a threshold would also guarantee that large, too-big-to-fail banks would be prevented from using changes to the capital requirements to unduly increase systemic risk.

Thank you, and I would be happy to answer any questions.

[The prepared statement of Mr. Jarsulic can be found on page 226 of the appendix.]

Chairwoman BIGGERT. Thank you.

Mr. Loving, you are recognized for 5 minutes.

STATEMENT OF WILLIAM A. LOVING, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, PENDLETON COMMUNITY BANK, AND CHAIRMAN-ELECT, INDEPENDENT COMMUNITY BANKERS OF AMERICA (ICBA), ON BEHALF OF ICBA

Mr. LOVING. Good afternoon, Chairwoman Capito, Chairwoman Biggert, Ranking Member Maloney, Ranking Member Gutierrez, and members of the subcommittees. My name is William A. Loving, Jr., and I am president and CEO of Pendleton Community Bank, a $260 million bank in Franklin, West Virginia. I am also chairman-elect of the Independent Community Bankers of America, and I am testifying today on behalf of its nearly 5,000 members.

Basel III was meant to only apply to the largest internationally active institutions, as opposed to community banks with their simple capital structures and conservative lending. Applying the same capital standards in addition to the many other new far-reaching regulations that will soon become effective will undermine the viability of thousands of community banks.

In numerous ways, these rules strike at the heart of the community bank competitive advantage: customized lending based on firsthand knowledge of the borrower and the community. We ask

you to support an exemption for banks with assets of less than $50 billion in size.

There are many overreaching provisions of Basel III in the Standardized Approach. Individually and collectively, they will fundamentally reshape the United States financial industry. I will begin my remarks with the impact the rules will have on residential mortgage lending.

New risk weights on certain residential mortgages will impose punitive capital charges on all but standardized, plain-vanilla loans. Customized loans such as balloon loans, a staple of community banking, would move from their current 50 percent risk weight to a minimum of 100 percent and potentially 200 percent, though they are fully secured by real estate.

In the rural areas I serve, many loans are ineligible for sale into the secondary market because they lack comparables or because the house sits on an irregular or mixed-used property. I am happy to hold such loans in my portfolio, but the only way I can protect my bank against interest-rate risk is to structure the transaction as a balloon loan, typically with a 5- to 7-year maturity.

I and other community bankers have safely offered balloon loans for decades. Because I retain these and other loans in my portfolio, I have a vested interest in their performance. I am not aware of any data whatsoever that demonstrates that balloon loans are more risky than other types of credit. I would have to seriously reconsider making these loans with a 100 percent risk weight, let alone 200 percent.

Second liens, like home equity loans and home equity lines of credit, would also become impossible under the new risk weights. Prudently underwritten second liens serve a vital role in the lives of homeowners: financing property improvements; sending a child off to college; or starting a small business.

The new risk weights will drastically curtail residential lending in the rural and underserved areas that community banks serve, including mutual and thrift institutions. This is especially true if combined with new rules on Qualified Mortgages, Qualified Residential Mortgages, and other issues.

I will note one additional provision that will undermine community bank regulatory capital. Requiring us to include unrealized gains and losses on certain investment securities will create volatility where stability is paramount. When interest rates rise—and they surely will—today's paper gains on Treasuries and other securities will rapidly become paper losses. The sudden adverse impact on capital levels will be substantial, though the banks' actual ability to absorb the losses will remain unchanged. Large banks manage these risks with interest-rate derivatives that are simply impractical for community banks. Volatile capital levels send the wrong signal to the public, depositors, investors, and regulators.

Many additional provisions are nearly as troubling, and the total impact, as I have stated, could increase consolidation and reduce the number of community banks. An economy dominated by a small number of very large banks offering commodity products would not provide the same level of competitive pricing and choice and would definitely not be in the best interest of consumers. Small

towns in rural areas will face curtailed access to credit and economic stagnation.

Thank you for convening this hearing and helping to raise the profile of a significant economic policy issue with far-reaching and still unappreciated applications. Your letters to the bank regulators, both in their thoughtful quality and their sheer number, have hopefully made a significant impression. We look forward to working with you in this committee to obtain a full exemption on Basel III and the Standardized Approach for banks with less than $50 billion in assets.

[The prepared statement of Mr. Loving can be found on page 242 of the appendix.]

Chairwoman BIGGERT. Thank you, Mr. Loving.

Mr. Poston, you are recognized for 5 minutes.

STATEMENT OF DANIEL T. POSTON, CHIEF FINANCIAL OFFICER, FIFTH THIRD BANCORP, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION (ABA)

Mr. POSTON. Chairwoman Capito, Chairwoman Biggert, and members of the subcommittees, my name is Dan Poston, and I am chief financial officer of Fifth Third Bancorp, a regional bank based in Cincinnati, Ohio.

Fifth Third, like most other regional banks our size, is a traditional banking organization. We are domestically focused, serving our local communities by providing traditional banking services, primarily consumer and business loans, deposits, trust and related services. We are not complex or interconnected, and we do not have large trading or capital markets businesses.

We strongly support standards for appropriate levels of high-quality bank capital. We also support a more risk-sensitive system that applies broadly and treats similar risks with similar capital treatment.

There are 7,000 banks in the United States, the vast majority of which are community-based banks. Therefore, any general risk weights must work for these banks or else they don't work. We believe that such an approach would be entirely appropriate for regional banks like Fifth Third, whose risks are those of a traditional bank.

U.S. bank capital levels are now at historic highs. The issue is not whether U.S. banks have the capital for these rules; the vast majority of us do. It is the complex way that the rules would operate that would be so damaging to our customers and to the United States economy overall.

For example, the proposed risk weights would double the capital required for certain traditional mortgage products. The proposed rules are especially punitive to home equity lines of credit, which have not demonstrated the risk implied by these rules. We believe the rules as proposed would reduce mortgage availability, tightening credit and raising the cost of these products for borrowers and reducing credit to small businesses that use equity in their homes to start up and support the growth of their companies.

The risk weights would also raise costs and reduce credit availability to many commercial borrowers.

We strongly recommend that the Standardized Approach be withdrawn. The proposed risk weights have never been studied as part of a capital framework. There is time for the careful study that is absolutely critical to ensure consistent and workable rules for all. This is especially the case given that this proposal goes beyond any Basel agreement and is not required by any Federal legislation.

All banks, large and small, would benefit from an effective but much simpler replacement for Basel I than the one that has been proposed. Banks large and small have voiced very strong and remarkably consistent concerns about the complexity and burden of the proposed Standardized Approach.

We very much appreciate that the banking agencies have indicated that they are carefully considering these concerns and will take them into account. We look forward to working with the Members of Congress, banking regulators, and others to address these issues for the good of all.

I thank you for your time today and will gladly answer any questions you have.

[The prepared statement of Mr. Poston can be found on page 304 of the appendix.]

Chairwoman BIGGERT. Thank you, Mr. Poston.

Mr. Smith, you are recognized for 5 minutes.

STATEMENT OF PAUL SMITH, CPCU, CLU, SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY

Mr. SMITH. Chairwomen Biggert and Capito, Ranking Members Gutierrez and Maloney, and members of the subcommittees, thank you for providing State Farm this opportunity to testify on how the Basel proposals impact savings-and-loan holding companies, particularly those engaged in the business of insurance.

I have a written statement for the record which I would like to summarize, and then I look forward to the questions at the close of the panel.

State Farm is a proponent of strong capital standards, and we appreciate the complexity facing the Federal Reserve as they enact Dodd-Frank. However, applying a banking framework to companies predominantly engaged in the business of insurance is fundamentally flawed. It entails costly and questionable reporting requirements and favors structuring capital in a manner making insurers financially weaker, not stronger.

We are also asked to spend hundreds of millions of dollars developing new accounting and reporting systems that provide little, if any, added benefit over current conservative accounting systems required by State law. Effectively, this new system would be used exclusively to complete a form that does not add value to the safety and soundness of the financial system.

We do not believe applying the Basel framework to insurance-based savings-and-loan holding companies is required by Dodd-Frank and, in fact, think doing so runs counter to congressional intent, as expressed most recently by Senator Collins in a November 26th letter to the leadership of the Federal Reserve, the FDIC, and the Office of the Comptroller of the Currency. Instead, the Board

should utilize longstanding and effective State-based insurance regulatory requirements in setting minimum capital standards for insurance companies.

Finally, unless the Board is willing to accept the State-based capital rules, which it appears reluctant to do, we believe the Board should repropose specific governing rules for insurance-based savings-and-loan holding companies.

I would like to share a little bit about State Farm. State Farm Mutual Automobile Insurance Company is a mutual company founded in Bloomington, Illinois, in 1922. Through a network of 18,000 independent contractor agents and our staffs throughout North America and with an employee base of 68,000, we are the largest home and auto insurer in North America.

These businesses—property and casualty insurance—comprise 85 percent of our revenues. Adding in our life business, which was founded in 1929, brings that revenue number to 98 percent. We are clearly primarily in the business of insurance.

Our thrift comprises about 2 percent of our revenues but provides important convenient service to customers in the middle market. State Farm Mutual Automobile Insurance Company, our primary automobile insurer, sits atop our holding structure. And that is important because, as you listen to the testimony, you have heard the discussion about holding companies that own insurance companies or banks that own insurance companies. Our holding company is an insurance company, and it is not recognized within the regulations.

Banks and insurance are very different. Banks take deposits, which are liabilities on the bank's balance sheet since depositors can take their money back at any time. In sharp contrast, insurers collect a premium to pay for fortuitous or unplanned events.

Effective capital management of insurance companies is driven by matching our liabilities and our asset durations. Unfortunately, the banking regulatory model does not account for the nature of insurance liabilities and punishes holding longer-term assets. For a life insurance company, in particular, with long liability horizons, short-term banking regulatory preferences actually encourage asset-to-liability mismatches.

Similarly, banking rules ignore the nature of property and casualty liability risks faced by the insurance industry. Ironically, since many lines of P&C are of shorter duration, we could envision satisfying minimum capital standards under banking rules at levels that would garner regulatory action at the State level. So we would actually be looked at as well-capitalized for banking purposes and fail regulatory capital rules on the insurance basis.

This was recognized in a joint report with the NAIC and Federal Reserve staff. And I will quote from a report that was written in 2002: "The effective regulatory capital requirements for assets, liabilities, and various business risks for insurers are not the same as those for banks. And effective capital charges cannot be harmonized simply by changing the nominal capital charges on individual assets." As the rules have come out, that is exactly what we have tried to do, and it is simply not an effective regime.

When you take the bank-oriented rules and combine them with the uncertainty regulators have created for insurers through the

lack of specific rulemaking on the Volcker Rule, where insurance thought longstanding State-regulated investment rules applied, one wonders if there is any meaningful regard for insurance issues among Federal regulators.

My time is up, but the bottom line is that banking rules do not work for insurance companies and, we believe, are inconsistent with legislative intent. We are respectfully asking for rules that make sense.

Thank you.

[The prepared statement of Mr. Smith can be found on page 317 of the appendix.]

Chairwoman BIGGERT. Thank you, Mr. Smith.

We are having a vote right now, so that is why some people have left. They will hopefully be back.

Ms. Wilson, you are recognized for 5 minutes.

STATEMENT OF GINA WILSON, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, TIAA–CREF

Ms. WILSON. Thanks very much. Chairwoman Biggert, Chairwoman Capito, Ranking Members Gutierrez and Maloney, and members of the subcommittees, my name is Gina Wilson, and I am executive vice president and chief financial officer of TIAA–CREF. I appreciate the opportunity to testify regarding your concerns about the regulatory proposals to implement an enhanced capital regime for banking organizations.

TIAA–CREF is an insurance company with a not-for-profit heritage and the Nation's largest private provider of retirement benefits. Our primary goal is to ensure the lifelong financial well-being of our 3.7 million clients working in the academic, research, medical, and cultural fields.

Many of our clients have lifetime relationships with TIAA–CREF and trust us to provide for their long-term financial success. To ensure that we are meeting our clients' needs, we offer a comprehensive set of low-cost financial products and services, and among those services is a small thrift institution that allows us to offer our clients the option of banking with a company that they know and trust.

While our thrift company is less than 2 percent of our total assets, it still brings us under the purview of the Federal Reserve, and therefore subjects our entire organization to the capital regime contemplated by the regulators.

TIAA–CREF believes in having a set of robust capital rules governing financial institutions, and it is essential to increasing the safety and soundness of the financial system. We also believe the structure of the capital rules needs to account for the unique business models of the firms to which the rules apply.

The Federal Reserve's approach, however, is built solely on the banking business model. As a result, the proposals fail to adequately consider both the vast differences between insurance and banking and the potential negative consequences of applying a bank capital structure to an organization like TIAA–CREF that has a small bank but is overwhelmingly engaged in insurance.

Let me be clear. We are not asking for an exemption from the proposal. We believe that imposing the proposed structure without

consideration for the existing strict capital rules to which insurers already adhere would negatively affect TIAA–CREF's ability to offer our clients a full range of reasonably priced products and services. Therefore, we are asking the Federal Reserve to integrate the existing insurance capital rules into the proposals as they move forward with the final rulemaking process.

In drafting the proposals, the Federal Reserve has taken the position that the Collins Amendment to the Dodd-Frank Act, which was intended to permit due consideration of insurance companies involved in banking, prohibits them from treating insurance assets differently from banking assets. We respectfully but definitively disagree with this interpretation. We believe that the Collins Amendment provides regulators with ample flexibility to integrate the existing insurance regulatory capital regime into their proposed model.

Just this week, Senator Collins confirmed our interpretation of her amendment in a letter to regulators. In it, she states that she hopes regulators will "give further consideration to the distinctions between banking and insurance." The Senator also goes on to note that Congress did not intend for Federal regulators to supplant prudential State-based insurance regulation with a bank-centric capital regime. We appreciate Senator Collins' comments and believe that they provide the Federal Reserve with a clear path forward.

In our written testimony and in our comment letter, we have outlined two viable alternative approaches that would allow the Federal Reserve to incorporate the existing insurance regulatory capital regime into the proposals. These alternatives would accommodate insurers who own thrifts, while still imposing a robust regulatory structure on all banking organizations. We hope regulators seriously consider these alternatives, especially in light of Senator Collins' letter stating that it was the intent of Congress that they do so. We also ask the members of the subcommittees to keep these viable alternatives in mind as you work with and talk to the Federal Reserve about this initiative.

Thank you for your interest in our issues. Your assistance and support is invaluable in complementing our own efforts to ensure that the final rules adequately consider the business of insurance. And I look forward to answering any questions you may have.

[The prepared statement of Ms. Wilson can be found on page 326 of the appendix.]

Chairwoman BIGGERT. Thank you.

We will now turn to Members to ask questions, and I will yield myself 5 minutes.

While the proposed Basel III rules are intended to reduce the ability of banks to take excessive risks and damage the economy, it seems like the very nature of the business of insurance is not to take on excessive risk.

Could the proposed Basel III rules unnecessarily harm insurance consumers, the industry, and the economy, particularly those that might have a holding company or a bank?

Let's start with you, Ms. Wilson, and then go to Mr. Smith.

Ms. WILSON. I would say that the potential harm to our policyholders is indirect, in that the risk-weightings for longer-dated as-

sets, which are really necessary for us to provide retirement benefits, would cause us potentially to look for less long-dated assets. And that would actually create risk for the organization and potentially harm the returns that we can earn in supporting those retirement benefits.

Chairwoman BIGGERT. Okay.

Mr. Smith?

Mr. SMITH. Yes, I agree with Gina on that. And I would only add that the cost of compliance—so we use a State-based regulatory system for our reporting, a statutory accounting that is auditable. And a conversion to a GAAP statement for the State Farm organization would run a cost of somewhere in the neighborhood of $150 million and over 4 years to implement.

Those are costs that would go toward regulatory compliance and wouldn't be available to support our policyholders. So, along with just the disconnect with the risk-weightings, you also have the issues of cost of compliance that I think are a negative impact to the industry.

Chairwoman BIGGERT. Okay.

Mr. Smith, can you envision a scenario where under the proposed Basel III rules, an insurance company could look solvent, but under State insurance regulations, the insurance company could be subject to regulatory intervention?

Mr. SMITH. Yes, in the property and casualty world, basically the majority of the risk is actually carried on the liability side of the balance sheet. It is in the loss reserves; it is not on the asset side of the balance sheet. And the assets are actually very conservatively managed because we have to have liquidity for unexpected events. And that conservative balance sheet fares very well under a Basel III framework but ignores the risks to the company.

So we have run some of our affiliates through a model that shows that it is actually shows the affiliates are well-capitalized at a time that we would—well-capitalized from a banking standpoint where they would be not well-capitalized or even subject to regulatory involvement at the State level.

Chairwoman BIGGERT. Thank you.

We are going to stand in recess for a few minutes. Mrs. Capito should be back, but I have to go vote. So we will be in recess.

[recess]

Chairwoman CAPITO [presiding]. I will call the committee back to order and recognize Ms. Hayworth for 5 minutes for questions.

Dr. HAYWORTH. Thank you, Madam Chairwoman.

I have a question for Mr. Garnett regarding your testimony. And of course, there is great concern about the harmonization and the universal application of capital standards, supervisory standards.

At this point, how do our efforts in the United States compare with international efforts in terms of implementing Basel III?

Mr. GARNETT. I think that we are probably on the same page with regard to the implementation of Basel III. As you may or may not know, we have been managing to what we think our interpretations are of Basel III for approximately a year now.

Dr. HAYWORTH. Right.

Mr. GARNETT. We are getting new roles and drafts quite frequently. But I would say that they were certainly ahead of us with regard to implementing Basel II, which we did not do here.

Dr. HAYWORTH. Right.

Mr. GARNETT. But with regard to an all-in, if I can say that, Basel III, I would say that we are probably on a similar pace.

I think the concerns with regard to the implementation of Basel III are similar, in the sense of we have raised in both continents, if I can say that, we have raised an enormous amount of capital; we have raised an enormous amount of liquidity; we have right-sized our organizations; we have simplified our organizations.

And the question we have now—and I think it is the same question that the Europeans have—is, where is the right balancing spot between when enough is enough and when we start to impair doing business that we should be doing business?

Dr. HAYWORTH. Right.

Mr. GARNETT. And I think that is what we are both struggling with. I think that, obviously, some of that had to do with the delay that we have seen here and most certainly has a lot to do with the delay that we have seen in Europe.

Dr. HAYWORTH. But presumably, you have to act in an anticipatory way because the cost of retrofitting—

Mr. GARNETT. Yes. I can't take the chance of nothing happening, nor have we. As I said, we are implementing and adhering to and making business decisions every day as if Basel III were with us.

Dr. HAYWORTH. And you have rightly noted the cost, the opportunity cost, if you will, of overregulating. If you never want to fall off a bicycle, don't get on; you just won't go anywhere.

Do you think that we risk—the further we go, do you think we risk tipping the balance in a way that is detrimental to our capital markets, to our opportunities for growth?

Mr. GARNETT. I think there has to be a line in the sand somewhere. I am not quite sure where it is.

Dr. HAYWORTH. But do you think it is somewhere within Basel III, Mr. Garnett? Do you think—

Mr. GARNETT. I think with regard to where at least we as an institution are adhering today to Basel III and the ratios that we produce, we believe as in institution we are well-capitalized, in a very strong position of liquidity, which is also, most people forget, a part of Basel III.

Dr. HAYWORTH. Right.

Mr. GARNETT. We have simplified. We stress ourselves six different ways every month. We are complying with the CCAR requirements that put us and several other financial institutions through significant stress tests via the Fed.

And it is my personal opinion, with the amount of capital that has been raised as a result of Basel III and other related requirements, that we are at a point now where we really need to stop and think, if you would, about how much more we need to go before we impair lending to consumers in the United States.

Dr. HAYWORTH. Right. That is an enormous issue and one, certainly, that I hear about on the community bank level. Because I have had very good people come to me and say, I can't get a loan

from my bank anymore because the regulators are leaning so heavily on them.

Madam Chairwoman, thank you. I yield back.

Chairwoman CAPITO. Thank you.

Mr. Miller, do you have any questions?

Mr. MILLER OF NORTH CAROLINA. I think Ms. McCarthy has more seniority, but she is being very gracious today.

Mr. Jarsulic, I am sure you heard my questions earlier to the earlier panel about living wills. And I know the answer was about the Orderly Liquidation Authority, but the idea of the Orderly Liquidation Authority is to be guided by what is in the living wills. You have to know what you are going to be looking for if one of the systemically important institutions goes bust and what is going to be required.

Are you satisfied with what New York Fed President Dudley described, I think earlier this week or last week, of the first round of living wills being the beginning of an iterative process, where now we are learning what the impediments will be? And we certainly know what a difficult time we would have; we have learned that. And ultimately, there may be changes to the banks as a result of the living wills.

Before the reforms of the New Deal, the deposit insurance, the prudential regulation, we didn't have financial crises every few generations, we had them every few years.

Are you satisfied with the pace of the living wills process?

Mr. JARSULIC. Let me say that I am not familiar with Mr. Dudley's speech. But I think that, looking at the level of equity that banks currently hold, I am not confident that the banks are really far away from the fragile state that they were in prior to this crisis. And, therefore, that puts a stronger weight on the ability of Federal regulators and Federal agencies to respond should something go wrong with one of these very large banks.

And I am not at all surprised that it has been very difficult for the banks and the regulators to converge on living wills given the complexity of the organizations that we are talking about. There was a study recently by people at the New York Fed looking at very large bank holding companies, and some of them have literally thousands of subsidiaries.

So to construct a plan to quickly and effectively resolve an institution that complex seems on some levels very, very difficult. And, therefore, it seems to me that adds impetus to the need to provide other safeguards and not to rely on a backstop should something go wrong. Therefore, capital requirements, I think, are extraordinarily important.

Mr. MILLER OF NORTH CAROLINA. I am all for more equity. And, obviously, the importance of having an equity cushion, a capital cushion if something goes wrong, makes it less likely that there would be a catastrophic collapse of a systemically important institution.

But just today there is an article that the Bank of England—their financial policy committee said that the banks may be overstating their capital because they are understating the risks with different kinds of assets, not really taking losses on troubled loans.

Would the same thing be true in the United States? It is pretty striking that the market value of the stock of almost all of the biggest banks is well below the book value, which suggests that the market doesn't quite believe their accounting.

Professor Admati, do you want to—

Ms. ADMATI. I commented about this in my written testimony, because when you ask how well-capitalized they are, the question is, what measures do you use for that? What measures of the equity, what measures of the assets, so that you can look at capitalization?

It is, in fact, the case that market values are very low. And in a book by Mike Mayo, an analyst, he estimated in 2011 that there are $300 billion in unrecognized losses. Some of what we see in terms of mortgage renegotiations, even eminent domain debates and all of that, has to do with banks—with the inconvenience of recognizing losses.

Of course, if you use accounting measures to measure capital, then you might look better than you actually are, and the market knows that. So I am quite concerned about the lower market values because those are the ones that are relevant also for raising equity. Unfortunately, the banks did lose, and, unfortunately, they are weak.

So I think the Bank of England is right spot-on in challenging the banks on giving a correct picture. And even in Europe, when they did their special requirements, which were very helpful to the banks that complied with them, they made sure that they recognized more losses.

When you have denial, as we saw in the savings and loans, as we saw in Japan and other places, that does not help the economy. Banking problems should be recognized early. We have potentially some zombie banks. The book claims that Bank of America and Citi might be insolvent, so we don't know.

Chairwoman CAPITO. The gentlewoman's time has expired.

I am going to recognize myself for 5 minutes for questions. I want to start with Mr. Loving.

In your statement and in other statements, it was mentioned, the Qualified Mortgage issue, the rule that is still pending. You and I talked about this when I visited the bank several months ago. And I specifically asked the regulators the question, as did a lot of other Members because there is a lot of concern.

Are you satisfied with the response in terms of that they are actually looking at the interplay between these two issues, very large issues, and how they could impact a bank of your size?

Mr. LOVING. It is certainly encouraging to hear that they are looking into it, but it is still concerning if the two would come together at the same time or even separate.

When you look at the definition of QM or QRM, if it is defined too narrowly, it could potentially force many institutions, community banks that provide much of the lending in rural and underserved areas, it could force them out of the mortgage market. And if you add to that the additional capital reserves that would be required by Basel III, it could be a big issue.

I am, as I said, encouraged that they are looking at it. I hope we have an answer soon on a definition of the Qualified Mortgage and hope it is not too narrow.

Chairwoman CAPITO. Thank you.

Mr. Garnett, could I ask you to educate me a little bit—I know you have been in risk analysis for a long time for a large institution. And we have heard a lot about risk-based assets and how they are going to be assessed.

But going forward—we can predict today what maybe the risk is on a lot of on financial instruments, but you have to have elasticity enough to be able to price the risk of the financial instruments of the future. And I think, obviously, from 2008, some of the risk was not properly assessed by the institutions or the regulators.

What advice would you have, looking forward—this is a little off-topic—but looking forward—because it is topical in terms of how you are going to set these regulations—that we are not pricing the risk-based assets today for Basel III but 5 years from now they are going to be insignificant because of the change in the marketplace? Do you have any thoughts on that?

Mr. GARNETT. I do. And inherent in any measurement using models, most usually look over their shoulder to help them conclude on whatever you are asking the model to conclude. And looking over your shoulder is not always necessarily going to give you the clearest path forward, as you said.

What has been done, and has been done not only by the industry but by the regulatory community, has introduced very rigorous stress testing, coming up with hypothetical scenarios to test our resolve and to test the loss-absorption capacity in our institution, whether that be testing liquidity or testing losses that may be absorbed by our capital or our reserves.

The CCAR is a perfect example of where I think the industry over the last 3 or 4 years has begun to do a lot more forward looking, a lot more hypothetical thinking, rather than simply relying on the past, which unfortunately is an inherent weakness with relying solely on models.

And that is one of the reasons, I think, that our regulators are not solely relying on Basel, they are not solely relying on recovery or resolution plans, they are not solely relying on new liquidity. But when you put the stuff together, it makes a pretty powerful package.

Chairwoman CAPITO. Thank you. I think that is an important issue to keep before the committee as we move through these next several years, because you can't anticipate—we were never able to really anticipate where the weaknesses were. Maybe we weren't looking hard enough or looking in the right places. But you always hear profit-makers are always a little step ahead of you, and so we know that is the case.

Mr. Poston, let me ask one last question. You heard the regulators express the fact that they were looking through the thousands of comments. How does that make you feel? Better? More relieved that they are actually taking this issue that has been brought to them by regional banks and others seriously? Or do you have any comments on anything you heard them say today that caused a red flag for you?

Mr. POSTON. I wouldn't say anything raised concern relative to a red flag. However, there are 2,000 comment letters, there are lots of different views with respect to these rules. Certain elements of the rules—the feedback from the industry has been remarkably consistent. And I am hopeful and encouraged by the fact that they have said they are committed to reviewing those comments and taking those comments seriously as they finalize these rules.

Chairwoman CAPITO. Thank you.

My time is up. I will say the consistency that—we also heard that consistently across both the Republican and Democrat side here as we raised the concerns.

Mrs. McCarthy?

Mrs. MCCARTHY OF NEW YORK. Thank you. And thank you for having this important hearing.

I will have to say, and I will repeat the chairwoman's words, there are many of us on both sides of the aisle who are very concerned about what the rules have been. Because it certainly was not our intent for those who had worked on this side of the aisle, the Frank side. We left the language that way because many of us do not believe that one-size-fits-all. You have insurance companies here, you have regional banks here, you have community banks here. They all have different models. So we were hoping, in their wisdom, they would understand that.

With that being said, though, I believe both sides of the aisle have been working. We will continue, in my opinion, to speak out very diligently to come up with a fair ruling. We do not—and this is something that Barney Frank said right in the beginning when we started working on the Frank bill. And it took us almost a year-and-a -half to do it. We took our time, trying to cover everything. Obviously, we couldn't cover everything. But with that being said, I think we did a very good job on that.

With that being said, I have a curiosity because the bottom line is what we are trying to do is protect our constituents. That has always been the bottom line for all of us.

So, Ms. Wilson, with your line of business—because I know that in your company you take care of middle-income families. They are nurses, they are teachers, they are all along those particular kinds of jobs. How would the changing of the rules as they seem to be going with the regulators, how is that going to impact your customers, your clients?

Ms. WILSON. Thank you very much for the question.

We serve about 3½ million participants, and we protect their retirement savings. And to the extent that these proposed rules and the risk-weightings for some of the longer, more diverse asset types in America will get a heavier risk-weighting, that might cause us to invest less in America for long-term construction projects, for long-term bonds for corporate America that are creating jobs.

And what that does to our participants is it actually potentially would reduce the amount that they will get in retirement, which to us is really the wrong answer. We have looked at the insurance regulatory regime for how much capital an insurance company needs, and it has worked very well for decades. And it is based on pretty rigorous analysis where the risk exists in the insurance products and in the assets we carry. And if we can't get that match

between the long assets that we buy and the long promises we are making, we could potentially disadvantage our customers.

Mrs. MCCARTHY OF NEW YORK. Just a very quick, maybe a yes-or-no answer: During the really rough years, did any of your clients lose their monthly check?

Ms. WILSON. They did not. In fact, we probably benefited indirectly from the crisis, in that we had more people who were willing to trust their money with us.

Mrs. MCCARTHY OF NEW YORK. Excellent.

Mr. Loving, when you had given your testimony, you basically came up with the banks not being looked at for—you put a price tag on it, $50 billion. How did you come to that particular amount of money?

Mr. LOVING. The $50 billion aligns itself with the limit that was set in the Dodd-Frank for the systemically important institutions. And so that is where that limit came from as a cutoff for those that should be exempted from the Basel III.

Mrs. MCCARTHY OF NEW YORK. Just following up a little bit, if the rule goes into effect as the FRB proposed, what do you think will be the bottom line, Ms. Wilson, on your company?

Ms. WILSON. We will have to see what the final rules look like before we have a full assessment. Right now, we are doing modeling to see what it would look like under the proposed rules. And we are probably going to have to make some changes to our investment philosophy, if you will.

Mrs. MCCARTHY OF NEW YORK. I would say to all of you that this is one of those issues, whether the full committee agreed with Dodd-Frank or not, that we are working together again to try to—certainly, because we don't want to stifle the economy. But the bottom line is we want to make sure our constituents are protected. It is all of your reputations that are on the line to do the best for them. Because if your reputation goes down the tubes, you are not going have any clients, and that is the bottom line.

Thank you for your testimony, and thank you for your patience basically the whole day.

Thank you. I yield back.

Mr. CANSECO [presiding]. The Chair recognizes Mr. Luetkemeyer for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

I will yield my spot in line to the gentleman from Ohio if I can pick back up after him.

Mr. CANSECO. Certainly.

Mr. LUETKEMEYER. He has another committee to go to. Thank you, sir.

Mr. CANSECO. Okay.

Mr. Stivers?

Mr. STIVERS. Thank you. I appreciate the gentleman from Missouri allowing me to scoot up a little bit.

I appreciate all the witnesses' testimony. My first question is for Mr. Poston.

You talk about in your testimony the concern about the Standardized Approach for risk-weighting. And, I was really taken by a point you make on page 7 about how some nonperforming loans ac-

tually are seen as less risky than home equity lines of credit and other mortgage products.

Would you like to talk about that a little bit? Because that does seem incomprehensible, that a nonperforming loan would be less risky than a loan that is performing.

Mr. POSTON. Yes, I think your question gets to a point that I think has been one that many in the banking industry have focused on, and that is the treatment of mortgage loans and the treatment of home equity loans. And the risk-weighting with respect to those categories of loans has been made excessively more complex than it has been under prior rules and is very punitive, in the view of most in the industry.

So the example that you point out gets to the inappropriateness, in our view, of the risk-weightings of mortgage loans and home equity loans and what we believe will have a significant negative impact on our customers in terms of the availability of that type of credit as well as the cost of that type of credit.

Mr. STIVERS. Thanks.

And with regard to that, sort of a formulaic approach to risk-based weighting, where the regulators assume they know exactly what the risk of every potential problem is, seems to me like it is very problematic because, in my experience—I have been in the Army 30 years, and the generals always want to fight the last war. And this appears to me like we are creating a Maginot Line that the regulators today believe is impenetrable. And, as we all know, in World War II they just found another way, and we don't always judge the right crisis.

Does anyone else want to talk about the concerns of sort of the standardized risk-weighting? I know that in Mr. Loving's testimony, it was something you addressed. Is there anybody else who has concerns about it, the formulaic approach where we pretend to know exactly what the risks are in some mathematical formula?

The professor is shaking her head. Maybe she would like to address something, too. Mr. Loving first, maybe, and then the professor.

Ms. ADMATI. Oh, sure.

Mr. LOVING. Yes. When you look at the Standardized Approach and the risk weights that are applied, it does create some question as to the real estate marketplace and the risk weights that are placed on certain real estate loans versus other components, whether it be commercial loans or home equities. They all carry a different level of risk, but I am not sure that a 200 percent risk weight is the appropriate level on a balloon mortgage or even a home equity.

Mr. STIVERS. Go ahead, Professor.

Ms. ADMATI. Yes, it seems like they are fighting the last war in a very narrow way. They are not learning the really big lesson, which is more what you said, that it is an illusion that we can measure these things, that there are a lot of things, that it is sort of about unknowns, it is about having an actual buffer.

Even in the stress testing, by the way, there is a lot of reliance on models.

Mr. STIVERS. Right.

Ms. ADMATI. How would you predict, and do you know the contagion mechanism, and do you really know what AIG is holding, and do you really predict these things?

So we should be humble about our ability to do this modeling. And I am saying this as a theorist in finance.

Mr. STIVERS. Great.

Mr. POSTON. If I could just add to that, I think—

Mr. STIVERS. Sure.

Mr. POSTON. —the other concern, I think, with the risk weights, in our view, is that those risk weights are driven off of qualitative factors largely about product structure and not on the elements that we believe drove risk and drove losses through the last crisis. And those are more things about how the loan is underwritten, what the debt-to-income ratios are, what the FICO scores are, what the creditworthiness of the borrower is.

So, in our minds, being more risk-sensitive makes a lot of sense, but the rules seem to focus in on the wrong thing.

Mr. STIVERS. Sure. And to follow up on that, Mr. Poston, do you think that capital rules should be tailored to the complexity of the institutions that are covered at all or—

Mr. POSTON. Yes, we would support capital rules that are related to the complexity, but I think it is important to recognize that it is the complexity of the activities that are going on—

Mr. STIVERS. Right.

Mr. POSTON. —that needs to be focused on. So I think focusing on the complexity of derivatives activities or capital markets activities, international activities is appropriate. One thing I think that concerns me, concerns Fifth Third, concerns some regional banks, is that size is sometimes used as the only barometer of risk.

Mr. STIVERS. The proxy.

Mr. POSTON. And I think these rules really need to look at the underlying activities and make sure that for the same underlying activity, irrespective of the size of the bank, it gets the same capital treatment.

Mr. STIVERS. It is what you do, not how big you are.

Mr. POSTON. Absolutely.

Mr. STIVERS. I yield back the nonexistent balance of my time, Mr. Chairman.

Mr. CANSECO. Thank you, sir.

The Chair now recognizes the gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you all for your testimony. We have a lot of activity today, and the caucusing on the Floor, and many of us could not be here the whole time. I would like to ask Ms. Wilson and Mr. Smith, do you believe that the regulators have enough flexibility within the current law to structure the Basel rules to make distinctions between insurance companies and other financial institutions?

Mr. SMITH. I will take a shot at that first, and Ms. Wilson will clean up after me. I think, clearly, if we consider the legislative intent, and as confirmed by Senator Collins in her letter early this week, the equivalency is the test, not the same set of rules. And so if you apply an equivalency standard, you can actually use the insurance-based model and say, what is equal to the capital

strength that would be applied within the Basel framework to a bank, and not necessarily formulaically apply that same set of rules.

And so I believe, yes, there is flexibility within, and clearly legislative intent to deliver that flexibility that Basel III is a floor. It was not a formulaic approach. It was an intent to get equivalency of capital standards. And there are clearly a lot of strengths in the State-based regulatory capital system that could be looked at for equivalency to the Basel rules as applied to banks.

Mrs. MALONEY. Ms. Wilson?

Ms. WILSON. I would agree. And I think the other important thing that the Federal Reserve has talked about is making sure that there is a floor and there is absolutely no impediment to making sure that you have this no less than, and the equivalency covered, even if you respect the insurance capital regime that is already in place.

Mrs. MALONEY. Okay. What changes, Ms. Wilson, could the regulators make that would possibly improve the situation and that will recognize the distinct business models of your organization, insurance, and other organizations? And also, Mr. Smith, if you would like to comment?

Ms. WILSON. What we had proposed in our comment letter were two different ways that the Federal Reserve could adjust their approach to recognize the fact that insurance companies are already well-regulated by State insurance regulators: one is referred to as the deduction approach; and the other one is a calibration approach. We think either one is a possibility.

If I could describe one, it is almost like looking at the two different parts of the organization separately, giving them a blended grade, and saying that is good enough. The other one is actually kind of doing an equivalency test between metric and sort of U.S. standards. So it is not that hard. We just think that it wasn't really considered.

Mr. SMITH. And I don't have really anything to add to that. I think the way that TIAA–CREF has proposed addressing this is very logical in looking at the existing system and adding to that and making sure you have a comprehensive view of the organization, but not necessarily forcing it into the same model.

Mrs. MALONEY. Okay, thank you.

And, Mr. Jarsulic, we heard testimony in our offices here today that the smaller community banks and regional banks, where they have said that complying with the Basel formula will mean that mortgages will be harder and more expensive to obtain and there will be less capital out there. Are you sympathetic to that argument?

Mr. JARSULIC. I am not sure precisely where they feel the increased cost is coming from. If the increased cost is coming from—

Mrs. MALONEY. They are talking about the 20 percent downpayment that a lot of people don't have. If you are a low- or moderate-income worker, you don't have a nest egg to put it down, and it might limit their ability to get credit and to get mortgages and to move forward.

Mr. JARSULIC. The claim seems to be that if we have to have greater equity backing the lending that we are doing, that is some-

how going to increase the cost of finance to us. And I think the data don't really support the notion that lower levels of leverage are correlated with higher costs. If you look at the historical data—there are some cited in my testimony—there does not appear to be a correlation between leverage levels and cost of finance. It doesn't seem to translate.

So while these banks may have other issues with some of the rules for mortgage lending under Basel III, it is not clear to me that there is going to be an increased cost of finance.

Mrs. MALONEY. I would like to see if Professor Admati and Mr. Loving and Mr. Poston would respond, but I also want to ask for comment on an article I was reading last night that said that Basel II had no capital requirements compared to Basel III. And then the swing from that, Basel II never went into effect, but that was the article that I was saying, that there was a tremendous swing.

And if anyone would like to comment also on community and regional banks. Of course, they are going to be regulated by Dodd-Frank, but should they also be required to go into Basel III even though they are not doing any international commerce at all? They are saying that it is going to really hurt them, and I would like to hear the panel's response to that.

Mr. LOVING. I will comment on that as it relates to community banks and being applied to Basel III. As I have said in my testimony, many of the provisions are going to create hindrances, in some cases, exit of the institutions from the mortgage market.

As was mentioned earlier, the possibility of QM and QRM coming into existence at the same time, although in itself they created a problem in themselves, if they come together, it will create real problems, and increase cost in trying to determine if it is a fully docked loan or not a full doc loan, and whether it needs to be a category one loan, or a category two loan, and simply the cost involved to determine whether it is a category one or a category two loan.

In our case, looking at previous underwriting, because we know our borrower, we would have to go back on a file-by-file review to determine if it meets the requirements of a fully documented loan, simply because we may not have required a verification of employment.

In our area, we know where they work, we know where they live, and we know what they make. And so that creates a significant problem for us and many community banks across the country.

Ms. ADMATI. I would like to comment on that. When you say Basel III, there are really two things there, there are the levels and there are the risk weights. The levels, I concur with Mr. Jarsulic's comments. On the levels of equity, there is no problem there except for transition. We want the levels to be higher so the downside is where the upside is. So there is just a question of being operating at the safe level, and not compare it to speed limit or something.

On the risk weights, there could be huge distortions. So I agree with the comments that this notion of complicating the matters and starting to fine-tune, exactly changing their incentives to do something versus another in one particular way, and then having the risk go some other places, what the regulations think are safer,

but are actually not safer, or becomes unsafe, that is not a good path.

So I am in favor and many academics are in favor of very high, and cruder, simpler kinds of requirements. But we especially want the markets to work. We want the markets to guide investments and funding decisions.

Mr. CANSECO. The gentlelady's time has expired.

And the Chair now recognizes the gentleman from Missouri, Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

I just want to talk with Mr. Smith for a second with regard to—Mr. Miller, back here behind me in the first panel, were you listening to his discussion?

Mr. SMITH. Yes.

Mr. LUETKEMEYER. He made some really good points with regard to the assessment of your securities that you invest in to offset the term of the investments that you make or the policies that you write.

Mr. SMITH. Right.

Mr. LUETKEMEYER. Can you give me some for instances here of the direct effect it would have on your business with regard to if they downgrade their securities so that you have to put additional securities in there, or you have to put more additional capital in there, how would you offset this situation to make sure it didn't impact or how does it impact, I guess, your portfolio of—

Mr. SMITH. I appreciate the question. I think we would ground the answer to that question in the fact that we are a very well-capitalized organization, and under any of these standards we show up as a well-capitalized organization. Relative to our business model, frankly, we wouldn't change, because for us to change the business model in response to the regulatory scheme would be a shame. And it would be inappropriately matching the assets to the liabilities.

If you forced the matching to be shorter term, so if you took the life insurance industry and put it in shorter-term duration assets, you effectively would be driving down the yields, or the crediting rates associated with the policies, and you would be hurting the policyholders who purchased it. The longer-term view with quality bonds is actually a very effective way to fund those long-term liabilities.

Mr. LUETKEMEYER. My question is, if the regulators come in and say that the quality of your bonds is not as good as you think it is and they start arguing with you about that, how does that impact your cost for the products that you have or are you going to have to go out and purchase different securities to match off or how would you solve the problem?

Mr. SMITH. The costs would increase if we had to move in that direction. Frankly, we would be faced with a decision as to whether we would stay in the banking business, which many of our competitors have made a decision to exit the business. It is a shame when the regulatory framework puts upon the industry a change that actually causes people to say, it is just not worth it because I can't conform.

And so, we are really faced with that decision at the same time we would face the funding decision. Given 98 percent of our rev-

enue is from insurance, it would really call into question the banking. And we feel that having a bank is actually good for the United States, so it is a positive thing.

Mr. LUETKEMEYER. I am asking with regard to the insurance portion of your business. That is where I am going with my question.

Mr. SMITH. It would raise the cost. It would raise the cost and it would make some products difficult to offer.

Mr. LUETKEMEYER. Okay, thank you very much.

Mr. Loving, with regard to all the community banks, they hold their securities to maturity most of the time. Very few of them trade their securities. So one of the things with Basel III here is that they want to look at every single security, and then making you charge off or add to your capital account the unrealized loss or gain from what you are doing here. And it is really difficult for a lot of the smaller institutions because obviously they hold them to maturity and it is not a big deal to them.

What effect do you think this would have on the smaller institutions with regard to their purchase of local bonds? In other words, a lot of your community banks will buy the local hospital bonds, they will buy the local sewer bonds, the local fire department bonds to help their own communities be able to build or help them to exist, provide the services for the community. How would that affect their ability to support the community with those types of investments?

Mr. LOVING. I believe that those particular investments will be looked at and will have to be looked at under additional requirements as to the value and the creditworthiness of that particular investment. There are some regulations coming down that guide us on how we value and underwrite those credits.

So I think there will be an impact. I think it will be a negative impact on the ability to hold and to buy those and there may be an impact on the value of that institution, or of that obligation that you are—

Mr. LUETKEMEYER. Do you think that you would probably cut back on the amount that you would invest, instead of 1 percent of your investments in local bond issues, maybe half a percent or something like that?

Mr. LOVING. Each institution would probably evaluate it differently and specifically, but, yes, I think in general, there would be a deduction or a decrease in the amount purchased and held.

Mr. LUETKEMEYER. Mr. Poston, Mr. Jarsulic made a comment with regard to the increased cost of mortgages, that he didn't think there was an increased cost. Would you like to make a comment about that?

Mr. POSTON. Yes, thank you. I think Mr. Loving addressed earlier some of the increased costs with respect to mortgage lending with respect the to the administrative costs, and I would certainly agree with those comments. The other thing I would point out is that perhaps in some of the discussion here of those who think that there is no significant increase in costs, they are not considering the cost of capital.

To the extent that a tremendous amount of additional capital is required to be held by that loan, that loan is in fact funded not by customer deposits, or not by borrowings which carry a much lower

rate, particularly in this rate environment, that cost may be half a percent, three-quarters of a percent. If you have to fund greater portions of that loan with equity, the cost of equity is 12 or 13 percent, so it is multiples of 20 times the cost in terms of the funding costs of that loan if it is funded with equity or capital, rather than borrowings or deposits.

Mr. LUETKEMEYER. Okay, thank you.

I see my time is up. Thank you, Mr. Chairman.

Mr. CANSECO. Thank you.

The Chair now recognizes the gentleman from California, Mr. Sherman, for 5 minutes.

Mr. SHERMAN. Thank you, Mr. Chairman.

Mr. Garnett, you might be best for this. Basel envisions marking to market those securities identified as available for sale. And I could imagine a bank having to decide whether a particular bond that had declined in value is available for sale. Does management pretty much get to pick which ones are available for sale and which are not?

Mr. GARNETT. No, they do not.

Mr. SHERMAN. What is the definition of a security available for sale?

Mr. GARNETT. It is a security that you want to have the ability to sell for liquidity purposes. It is not an asset you are going to hold to maturity, and it is not a trading account.

Mr. SHERMAN. Okay, but I am a local bank. I buy some water bonds, I buy some sewer bonds, I buy some school bonds.

Mr. GARNETT. Right.

Mr. SHERMAN. And every year, I have to decide what is my intention. Do I want to hold these to maturity or not?

Mr. GARNETT. At the time you purchase that security, you must determine.

Mr. SHERMAN. And that is permanent for the entire—so if I change—

Mr. GARNETT. That is where you start.

Ms. SHERMAN. That is where you start.

Mr. GARNETT. Right now. If you want to change and move a security that is held for sale into a held to maturity, it must be done at the current market value. So you can't simply ignore any gain or loss in that transfer.

Once you move it into held to maturity, it is there forever.

Mr. SHERMAN. So there is no way to, if a security has declined and you designate it as available for sale when you purchase it, there is no way to delay the recognition of the unrealized loss because you either keep it as available for sale and you would have to recognize that, or you redesignate it and that act causes the recognition.

Mr. GARNETT. Recognizing the loss, yes, sir.

Mr. SHERMAN. And if it was a security that you knew was going to go further down in the future, if you really knew that, you would sell it now?

Mr. GARNETT. That is correct.

Mr. SHERMAN. Okay. So really do have a mark-to-market on anything that wasn't designated as hold. What about the other direction, though? You buy a security. It goes up in value. And you had

it designated hold to maturity and now you want to make it available for sale.

Mr. GARNETT. You cannot do that, sir. Hold to maturity, you are stuck.

Mr. SHERMAN. Hold for maturity, even if you have called your broker and he is a minute before selling it, it is still not available for sale.

Mr. GARNETT. You might be able to sell it just before you go and visit the FDIC before they put you into resolution.

Mr. SHERMAN. Okay. On the other hand, if you actually sell an asset that was designed to be held for maturity, that is a recognition event that increases your capital if you sell at a profit.

Mr. GARNETT. That gain would already be recognized in your capital because you are already marking it to market.

Mr. SHERMAN. You are marking to market the hold to maturity securities?

Mr. GARNETT. No, I thought you said the—

Mr. SHERMAN. Okay, if you buy something and you are going to hold it to maturity, you put it in that account.

Mr. GARNETT. Yes, sir.

Mr. SHERMAN. It goes up in value a couple million bucks and you sell it. Have you increased your capital by a couple million bucks?

Mr. GARNETT. You cannot go to held to maturity and sell things prior to maturity.

Mr. SHERMAN. Wait a minute. I buy a 30-year bond.

Mr. GARNETT. Yes.

Mr. SHERMAN. I intend to hold it to maturity. For business reasons, a new business plan, after holding it for 5 years I want to sell it, and the banking regulators won't let me sell the bond?

Mr. GARNETT. In what account did you put it?

Mr. SHERMAN. The hold to maturity when I bought it but I changed my mind.

Mr. GARRETT. You cannot change your mind, sir.

Mr. SHERMAN. That is a hell of a straitjacket.

Mr. GARNETT. We can't blame that on the regulators. That is a very clear accounting regulation.

Mr. SHERMAN. Accountants, and I am one, account for what you do. We don't tell you, you can't do it. I have never heard of a business being told it can't sell an asset.

Mr. Poston, do you agree with that, that under existing bank regulations, if you buy something intending to hold it to maturity and after several years you decide it is in the best interest of the bank to sell it, you need liquidity, you are not allowed to sell it?

Mr. POSTON. No, I would disagree with that. I think you are allowed to sell it. The challenge and the problem comes in as to what are the consequences of you selling that. And the consequences are all other securities that you are classifying as held to maturity no longer qualify for that classification. So it is viewed as a privilege, that if you are going to classify securities as held to maturity—

Mr. SHERMAN. Wow. Let me move on to another question. Ms. Wilson, if the rule goes into effect as the Federal Reserve has proposed it, what is going to be the impact on your organization, TIAA–CREF?

Ms. WILSON. We would have to seriously consider whether we would make changes to our investment policy because there is a likelihood that longer-dated securities would be treated less favorably. One of the challenges with long-dated securities is the pricing varies substantially, so there is more volatility in those assets. And even though we intend to hold them for the duration, the volatility in the capital levels would be uncomfortable for us.

Mr. SHERMAN. As I pointed out with the first panel, an insurance company tends to have long-term liabilities. As long as my doctor is right about me, that is true. And you would try to match that with long-term assets. I believe, speaking of long-term, that my—oh, no my time has not expired.

Mr. CANSECO. It has, Mr. Sherman.

Mr. SHERMAN. The clock is inaccurate?

Mr. CANSECO. No, you are beyond—

Mr. SHERMAN. Oh.

Mr. CANSECO. That is all right. It is all right.

Mr. SHERMAN. I yield back to the Chair.

Mr. CANSECO. The gentleman's time has expired.

And the Chair will yield himself 5 minutes for some very brief questioning.

Ms. Wilson, if the proposed rule goes into effect as it stands right now, has your company considered de-banking?

Ms. WILSON. We have certainly looked at what other companies have done with respect to their depository institutions. We are aware that there are some other very large companies that have decided to get out of the banking business. We have some significant conversations ongoing with our board and within the management team. And we really would like to stay in the banking business because we think it is good for America and good for our customers, but if the rules don't change at all we will continue to discuss that.

Mr. CANSECO. And there is the balance of your shareholders, too.

Ms. WILSON. We don't really have shareholders. We are a not-for-profit, so this is all for benefit of our participants.

Mr. CANSECO. All right. If a company such as TIAA–CREF was forced to de-bank, where do you think its clients would end up and where would they take their money?

Ms. WILSON. Right now, they have a limited number of choices. In large banks that provide really diverse services. They obviously can take advantage of services from community banks. But when we are talking about some of our clients' needs, they include things like trust planning and stuff of that nature that we do now, and we would hate to have to give that up.

Mr. CANSECO. Thank you.

Professor Admati, do you have concerns that the overly complex Basel III requirements could encourage arbitrage amongst some of the more sophisticated banking organizations?

Ms. ADMATI. Arbitrage is always a problem. So arbitrage created the shadow banking system, and there are all kinds of ways that people always try to get around regulation. That is true for tax codes as well.

So the key is to kind of keep track of where the risk is going, how the risk is being spread. Industry can do well by moving the

risk to good places, spreading it efficiently, but it can accumulate in various places and some of the regulation can do that. But the key is really to not allow people to lay risks that they take on others. So that should be the objective, and that stability as well.

I just have to make one statement, which is that for more than 50 years, we know that the statement was just made that because equity has a higher required return than debt, that funding with equity is more expensive. We know that is false. I would teach that in every basic course. The risk has to go somewhere, just because some security pays more than others. By this logic, Apple is being crazy, or Wal-Mart, or all the other companies that fund with so much equity even though they are not required to. So this reasoning is just false. Somehow in banking they don't accept that reality, but the downside risk has to be borne by somebody.

Mr. CANSECO. Thank you for that comment.

Now, do you believe that the complex models included in the proposed rule, going back to the Basel III rule, have any kind of predictive model, or would it be more effective to rely on simpler measures such as leverage ratio?

Ms. ADMATI. I believe the models are very limited and I believe people trust them too much. I think that is the big conclusion, not that we need to tweak it that way and the other way, but that the approach is flawed.

So I think that, again, we have to watch the system, but we have to kind of step back and see what we are trying to do, which is maintain a stable system that doesn't run into too much trouble. Just like speed limits. And so we don't in speed limits go to the trucking companies and ask them for fancy models about, and then worry about whether they took account of the fog or the kid jumping in front of the truck. We have speed limits that try to maintain safe limits for trucks going through neighborhoods, and that is how we should view leverage. It is like speed.

Leverage creates unnecessary risk. Risk is good, but leverage risk is unnecessary. And that is what we have to reduce. So we should keep our eyes on the ball, basically, and I think the details of the accounting and the risk weights and the models, and that is just letting you forget what it is about.

Mr. CANSECO. Thank you.

Mr. Poston, could you tell us how you think the capital standards included in the proposed rule will affect your customers, particularly small businesses?

Mr. POSTON. I think the provision that will most significantly impact small businesses is one that we have talked about several times today already. And that is the way mortgage lending and home equity lending is treated by the Standardized Approach. Higher risk weights, particularly with respect to home equity lending, will be particularly difficult on small businesses, the owners of which often rely on the equity in their homes to provide the ability to borrow for the seed capital to start those businesses and to grow those businesses.

So I think with respect to our ability to help small business owners, that particular provision would be particularly difficult.

Mr. CANSECO. Would the proposed rule ultimately make the financial system riskier by shifting activity to less regulated corners of the market like Dr. Admati mentioned?

Mr. POSTON. Yes. I think in particular to the extent that rules start to be written that apply differently to different organizations, whether that is amongst different sized banks, or differences between non-banks and banks, the credit will flow to those areas where it is least regulated and requires the least capital. And that creates difficulties in terms of differential rules because then you start to create risk concentrations perhaps in places where they shouldn't be, and the flow of capital is suboptimal for the economy as a whole.

Mr. CANSECO. Thank you, Mr. Poston.

My time has expired, but I see that—Professor Admati, did I call you doctor out of turn?

Ms. ADMATI. You can call me Anat.

Mr. CANSECO. Okay. You wanted to say something.

Ms. ADMATI. I do want to say something because I want to make sure to not imply that the risk of somebody trying to evade regulation is a reason not to regulate. For robbers going into dark alleys, we don't tell the police not to go to the dark alleys.

Mr. CANSECO. No different. The speed limit being—

Ms. ADMATI. Exactly. So we need the police to go to wherever they are going to drive fast. And so therefore, the shadow banking system just presents an enforcement problem. But any regulation needs enforcement. So just because we would try to evade it does not mean we shouldn't try to regulate it. That is sort of an upside-down reason not to regulate, to say somebody will evade it, because then we are lost. Then, it is too bad.

Mr. CANSECO. Thank you.

The Chair now recognizes the gentleman from Michigan, Mr. Huizenga.

Mr. HUIZENGA. Thank you, Mr. Chairman. I appreciate that.

And once again here in Congress, we are trying to defy physics. I am supposed to be in another hearing upstairs as well. So my apologies for coming in a little late, and I will be leaving here. But I do have a couple of questions. And I appreciated the chairman's questioning. That is something I am quite concerned about as well.

But I had a question for Mr. Poston from Fifth Third here, a little bit about underwriting standards and loan underwriting standards, and I am just curious how that standardized approach will impact your underwriting if finalized?

Mr. POSTON. I think our underwriting standards are primarily designed for us to control and manage our risk. So, in a certain sense, those underwriting standards will continue because that is the way we manage risk.

The difficulty, I think, will be that we are now creating a standardized approach which has a totally different view of risk and will greatly complicate the underwriting process because not only are we trying to look at the things that we truly believe drive risk, we are also looking at measuring, trying to capture, create systems to capture and track other factors and metrics that we don't believe drive the risk solely for purposes of compliance with these—

Mr. HUIZENGA. So are you saying that risk on the East Coast versus perceived risk on the West Coast versus perceived risk in Cincinnati, or Grand Rapids, Michigan, may be different things?

Mr. POSTON. Absolutely.

Mr. HUIZENGA. Okay. I think that is part of the problem with this, is we may be trying to pound square pegs in round holes with some of this. Another quick question I have for you is, and I am trying to make sure I word this properly, but I think you have seen on both sides and from the earlier panel a lot of concern for the small community-based banks and the bipartisan concern there.

I think that most of the quite large banks are either going to be able to hire the compliance or be able to go in and work with regulators in a way differently than a Fifth Third-sized bank, whether it is PNC or Huntington or a number of those types of mid-sized regional banks.

And I am curious if you would comment a little bit on whether you are concerned that the proposed capital standards, whether they could impact with competitive balance between you as mid-sized banks and most banks really on either side of you. Is it possible that you could actually be at a competitive disadvantage?

Mr. POSTON. Yes, we could envision a situation where we are at a competitive disadvantage. As you mentioned, regional banks are kind of caught in between the truly large banks which often do have differentiated risks. They are pursuing activities, such as trading activities derivatives, international activities, et cetera, that are riskier and perhaps require more complex rules.

Our activities are largely traditional activities which are very similar to community banks and smaller banks. The regional banks are not often thought of as community banks because of their size, but the activities in which we engage are very similar, if not the same, as most community banks, carry the same risk as community banks.

And to the extent that we end up with rules that differentiate us because we happen to be above $50 billion, or some other threshold, it can create competitive balances which we are very concerned about, both for us as well as for our customers because it lessens our ability to provide to our customers those credit services that they need.

Mr. HUIZENGA. In less than about 30 seconds, does anybody else have anything that they want to add on that?

Professor?

Ms. ADMATI. Just one sentence: I am not concerned with equity levels. I think they can be way, way, way higher. And people misunderstand that there is really no cost to the economy for that.

The risk measurements are problematic, and I think there we need to sort of try to figure out how to apply them to different institutions. The insurance companies definitely—I haven't commented on that at all—but they do seem to have a different model. If you blend them, then it is not clear that everybody should do everything. So this is kind of my other comment.

Companies in the rest of the economy, we don't insist that all of them always exist. Somebody buying distressed community banks actually told me in private equity that he thinks there are too many of them, so maybe that is the case. I am sorry to have to say

that, but we do not support the existence of every single company. If a company has value to generate, it should be able to find funding for itself in the market. If it can't, then there might be a question about it.

Mr. HUIZENGA. Mr. Chairman, with your indulgence, I know I am over my time, but I am just curious if we could have the professor clarify a little bit on that.

Mr. CANSECO. Go ahead.

Mr. HUIZENGA. Thank you.

So you do or do not believe that maybe the smaller community banks may operate differently than a mid-sized bank versus the truly large banks and whether that is okay or not? It sounded to me like you were saying that we need to apply the same standards to all of them.

Ms. ADMATI. No, no, that is not what I was saying. The thing about the big banks is their ability to scale their risks to the extent that they do. For example, derivative trading. This is a huge concern. This is a way to hide a lot of risks, and to take a lot of risks and scale them up. You can take a little tiny bit of return, and scale it all up.

And so, the size is just really scary for the largest banks. So those are kind of in a whole category of themselves, and once they do a lot of trading and especially the ones on derivatives, there are three such banks in the United States, and we are talking trillions of dollars of exposure.

To the extent that the bank does traditional banking activities, you can sort of wrap your hands around that possibly a little bit better. Do they have skin in the game on their loans? Do they hold them? So debt can matter. I am not sure where the lines are drawn exactly in terms of how, it has already came up here, how you define a community bank, what does that actually mean. So we do have to look at the risk characteristic or nature of what they do.

But in principle, I think the regulation should aim not to interfere as much with what people do, but to make them be making their decisions in light of the risk of the investments and their appropriate cost of funding for the investment that is borne by investors.

Mr. HUIZENGA. Thank you, Mr. Chairman.

Mr. CANSECO. Thank you.

And on behalf of Chairwoman Capito, I want to thank all of the members of the panel for coming here and for your candor.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

This hearing is now adjourned.

[Whereupon, at 2:43 p.m., the hearing was adjourned.]

A P P E N D I X

November 29, 2012

Insurance and Housing Subcommittee and Financial Institutions Subcommittee Joint Hearing:
"Examining the Impact of the Proposed Rules to Implement Basel III Capital Standards"

Representative Gary Miller's Opening Statement

November 29, 2012

Thank you Chairwoman Biggert and Chairwoman Capito for holding this important hearing today to examine the Fed's proposed regulations to implement Basel III capital standards and Section 171 of the Dodd-Frank Act, the Collins Amendment.

There is no question that robust capital standards, when properly applied, will help protect our economy. But, we must proceed with caution - such standards can actually be detrimental to our economy if not properly applied.

Capital standards need to be set appropriately so that they can ensure the safety and soundness of financial institutions, without curtailing the creation and allocation of credit that our economy needs.

There is no question that the regulations we are here to discuss today will have a significant effect on stability in the U.S. and global financial system, the availability of credit to fuel economic growth, and the ability of small banks to serve their communities.

It is absolutely critical to our economy and the financial markets that the final regulations are appropriately designed to promote financial stability and economic prosperity. To achieve these objectives, capital regulations must be carefully crafted so as not to weaken business models or financial prudence.

The regulations need to make sense for the business models of the industries to which they apply. Not all companies have the same business model and risk profile so it is not workable to have one uniform capital standards regulation to apply across the whole spectrum of financial services companies.

For example, I am very concerned about the proposed rules' treatment of insurance companies that own a depository institution. The bank-centric, "one size fits all" approach of the proposed rules is inconsistent with safe supervision of insurance companies. The proposed rules could actually harm the solvency of an insurance company, which is exactly the opposite of what Congress intended.

Earlier this year, Chairman Bernanke acknowledged before this Committee that appropriate capital standards regulations should take into account the different composition of assets and liabilities of insurance companies.

Just this week, Senator Collins, the author of the language in the Dodd-Frank Act, sent a letter to the Fed, FDIC, and Treasury stating that "it was not Congress' intent that federal regulators supplant prudential state-based insurance regulation with a bank-centric capital regime."

I am deeply concerned that the proposed rules do not take into account the different business model and risk profile of insurance companies. The proposed rules also do not take into account the state regulatory standards for insurance companies that emphasize long-term solvency.

Crafting the Basel III rules is not an easy task for regulators, but we must make sure the regulations are appropriate to the business models of the institutions and do not hinder the proper allocation of capital. Getting the capital standards wrong would have a devastating effect on our economy and we must do what is necessary to avoid such an outcome.

"Examining the Impact of the Proposed Rules to Implement Basel III Capital Standards"

Testimony for hearing of
Subcommittee on Financial Institution and
Consumer Credit and Subcommittee on Insurance, Housing, and Community Opportunity
November 29, 2012

by Anat R. Admati
George G.C. Parker Professor of Finance and Economics,
Graduate School of Business, Stanford University

I appreciate the opportunity to testify about the important topic of capital regulation. I have spent much time in the last three years studying and writing on the relevant issues. I have also submitted with others two separate comments related to the implementation of Sections 165 and 166 of Dodd-Frank Act in spring 2012, one of which is attached to this document as an appendix. The views I will express are shared by many academics; they are briefly summarized in a letter signed by twenty academics, the text of which is also attached.

Basel III is an international agreement, but it is specified as a minimum requirement. Any nation can go beyond the minimum. As you will hear, in my view and that of my colleagues, Basel III is insufficient to protect the public from risks in the financial system. The claim that we cannot go beyond Basel and design our own regulation because this might disadvantage our banks in global competition is invalid. I attach a short piece on this issue.[1]

In my assessment, the banking system in the US is still weak and fragile, even if it is in better shape than the banking system in Europe.

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[1] My academic writings on the topic, as well as policy papers, presentations, opinion pieces and letters are available on this website http://www.gsb.stanford.edu/news/research/admati.etal.html. I have recently completed writing a book entitled *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It*, coauthored with Martin Hellwig (forthcoming in early 2013), which explains many of the issues, advocates for much higher equity requirements capital regulation, and explains the flaws in past and proposed capital regulation. For more details, see http://bankersnewclothes.com/.

How well capitalized are US financial institutions?

After posing this important question, the committee's letter proceeded to ask how financial institutions' "capital reserves" compare to the years prior to the financial crisis of 2007-2008.[2] The blending of the terms "capital" and "reserves" calls for an important clarification, because it points to a pervasive confusion that muddles the debate on capital regulation.

The term "reserves" generally refers to cash or, for banks, deposits with the central bank. Reserves are like is a "rainy day fund" that can be accessed immediately if necessary. One could say that banks, or other firms, "hold," or "sets aside" an amount or a fraction of their assets as reserves, for example to respond to natural fluctuations in depositors' demands. If reserves do not earn any interest, holding them is costly. Since interest rates are very low, banks can choose to hold significant reserves. Obviously, money on reserve is not used for making loans. Importantly, except at very high levels, reserves do not address the most critical issue related to financial stability, which is whether banks can absorb losses on their investments without becoming distressed. That's where capital comes in.

In banking, the term "capital" refers essentially to funding that is obtained not by borrowing. Elsewhere, unborrowed funding is called equity, and the word "capital" is not used in this way. When banks are said "hold capital" or "set aside capital," or indeed when the term "capital reserves" is used, the impression is created that capital and reserves are the same. But this is false. We do not say, for example, that Apple "holds 100% capital." Apple's equity is not sitting idle in reserves, and it is not actually "held" by Apple. Rather, Apple's shareholders hold Apple stock and Apple invests and generates profits for its shareholders. The same is true for bank equity or capital. Shareholders hold bank shares, banks also borrow from depositors and others and their shareholders are entitled to profits as long as debts are paid. Banks do not actually "hold" their capital.

Capital is analogous to a down payment when buying the house, which later becomes the homeowner's equity. A homeowner's equity is not sitting idle in reserve; it is invested in the house. Similarly, the banks' capital is put into loans and investments. Having more capital does not prevent banks from making loans

[2] I would extend the crisis into 2009, since banks still requested support well into 2009.

Are banks well capitalized? In my view, US financial institutions are very poorly capitalized. They might be in better shape relative to many European banks, but this statement does not speak to where the banks should be and can be.

In answering this question one important issue, which indeed the regulation struggles with, is how we measure the capital and relative to what it should be viewed. Capital regulation is generally based on accounting measures, but these are not always good indicators of financial health. Balance sheets are created in this country according to so-called Generally Accepted Accounting Principles or GAAP. Companies report a "book value" for their assets and liabilities or debts, and shareholder equity is the difference between them.

Because accounting rules often use historical values and allow significant discretion, there is frequently a discrepancy, at times substantial, between the book value of equity and its market value. Market values reflect how much investors would pay for the shares, which in turn is based on the views investors have about the strength of the company. The market value is often significantly above the book value for healthy non-financial companies. For example, October 31, 2012, the book value of Wal-Mart equity was about $73 billion, whereas the total market value of its shares was almost $253 billion, higher than the total book value of the company's assets. Whereas Wal-Mart has over $40 billion in long-term debt, it can obviously absorb significant losses without becoming distressed.

Banks' market values are currently low relative to their book values. For example, JPMorgan Chase reported almost $200 billion in shareholder equity on September 30, 2012, but the value of all its shares was only about $154 billion at that time. Its total assets were reported at $2.32 billion. (It would be even larger if it was not allowed to net out about $1.8 trillion in derivatives, as GAAP allows but accounting standards in Europe do not.) Bank of America reported over $238 billion in shareholder equity, but the market value of all its shares at that time was barely over $95 billion, significantly less than a half of the book value.[3] The total assets of

[3] An important issue is how accounting standards treat derivatives and what they allow to be left "off balance sheet." With respect to derivatives, there is a controversy over whether to allow "netting" of derivatives. The International Financial Reporting Standard that is used in Europe does not allow as much netting as is allowed in the US. The impact is dramatic for the banks involved with derivative trading, such as JPMorgan Chase, Citigroup and Bank of America, increasing their assets and liabilities by more than $1.5 trillion in the case of JPMorgan Chase. See ISDA (International Swaps and Derivatives Association) "Netting and Offsetting: Reporting Derivatives under GAAP and under IFRS." http://www2.isda.org/functional-areas/accounting-and-tax/gaap-us/.

the bank were reported as $2.26 trillion, and would again be much larger by international accounting standards.

Banks were considered to be in good shape before the crisis. Even Bear Stearns was considered strong months before it collapsed. As it turned out, an enormous amount of risk built up in the system. Investors and regulators did not realize it or did not want to recognize it. The consequences were disastrous. In the crisis, market values plunged, credit froze, and the government and Fed intervened massively to support the banks and the system. Yet, throughout the crisis, banks' accounting-based capital ratios did not change very much. You would not know there was a crisis looking at them. The market values told a different story, being high prior to the crisis and then plunging.

The low valuations of banks reflect the simple fact that banks lost a lot of money on mortgages and other investments, and they face a lot more losses, as well as various legal costs. Investors know it but the balance sheets do not reveal the full situation, instead painting a rosier picture. Mike Mayo, a bank analyst, estimated in 2011 that there are about $300 billion in losses that are not recognized on the balance sheets of the banks because accounting rules have so much discretion.

The low valuation of Bank of America raises serious doubts about the health of the bank. A recent book called *Zombie Banks* by Yalman Onaran claimed that both Citigroup and Bank of America are insolvent, along with banks in Spain, Germany, Ireland and elsewhere. This means that if one actually were to recognize all their losses, their equity would be wiped out. Why do they still survive? Because there are ways in which they can muddle along and try to recover. They can borrow at extremely low rates, be paid significantly more by some borrowers, avoiding foreclosures or loan restructuring so as to avoid recognizing losses and deny their borrowers the opportunity to enjoy the low interest rates. Moreover, the banks' equity values are low even though they benefit from substantial implicit guarantees.

When there is little equity, a small loss can lead a homeowner to become underwater, as many have found in recent years. Distressed or underwater homeowners do not invest in their houses as much and might default or walk away if they can. The same happens to distressed companies: they do not make efficient investments, either avoiding good ones, or taking too much risk or even looting the property if default is imminent.

When banks or financial institutions become distressed, this can interfere with their willingness to make loans through an effect called debt overhang. This is the same effect that leads homeowners with little equity to underinvest in their home harms. Debt overhang leads some investments to seem unattractive to a borrower, because they benefit creditors at the borrower's expense. Distressed banks make very poor lending decisions, either being too conservative or too reckless. The experience of Japan and our own S&L crisis of the late 1980s show that it is much better to face problems in banking early and it can be much more costly to wait.

The distress or "failure" (even through the best resolution mechanism) of large, global banks that are highly interconnected or "systemic" can cause even more harm, because it can affect the entire financial system through various contagion mechanisms that we have seen play out in the crisis. These including effects on counterparties through contractual connections, information contagion, and the possibility of distressed sale leading to price declines and thus further weakening the system.

Maintaining a stable financial system should be the key focus of financial regulation, and it should strive to reduce the dependence of banks on the vast and highly distortive safety net. This safety net has grown unnecessarily. Instead, we must strive to move to a system in which losses are borne in the private markets, and where that those who take risks and benefit from the upside do not impose the downside on others, particularly not on the public. Financial stability should not require taxpayers to bear losses.

Banks can be safer bear more of their losses through the private markets. Basel III aims to move in this direction by requiring more equity, but the levels are still very low without justification. The claims that there is a tradeoff between having a safe financial system and lending or economic growth are false. So are the claims that there is a relevant cost to society of transitioning to a system where banks have much more equity than Basel III allows.

The transition

The prevailing view, even within the regulators, is that the banking system needs significant time to adjust to higher capital requirements. But this view is not justified. For example, it makes no sense to allow banks to make payouts such as dividends before satisfying Basel III. If banks used the same funds to make loans or repay some of their inessential debts, the

economy will only benefit. If Basel III is viewed as the target, why allow banks to move away from it?

Instead, the transition can be managed even more forcefully. Any viable bank, particularly those whose equity is traded in the stock markets, can raise equity at appropriate prices. Banks that cannot raise equity may not actually be viable and regulators should make sure they are not insolvent.

How much capital?

Banks do not need to borrow as much as they do. No healthy corporation in the economy has anywhere near the level of indebtedness that banks maintain, even though we do not regulate how much most companies borrow. Nothing that banks do necessitate that they are so highly indebted. Banks can do everything better if they had more equity.

Yet, banks fight to continue to live on the edge. Regulators and others seem to accept that the equity levels that we have gotten used to are somehow appropriate or that there is a cost to increasing them significantly. Basel III requires 4.5% equity to so-called "risk weighted assets," (plus 2.5% "conservation buffer," also relative to these risk weighted assets). Only some banks are subject to a simple leverage ratio requirement and that is set at somewhere between 3% and 4% depending on what is included in the denominator. I command the Fed for including in one of these measurements off balance sheet entities. However, I still find the levels outrageously low. There is actually no scientific basis for these numbers, and there is no relevant cost to society from increasing them dramatically.

Instead of taking clue from recent history, let's go further in time. In the middle of the 19th century, banks had 40% or 50% equity; back at the start of the 20th century, banks routinely had 25% equity, without any regulation. This did not necessarily make them safe, but the reasons were different. The increased reliance on borrowing matches the expansion of safety nets for the banking system, such as the creation of the Federal Reserve, and deposit insurance.

If anything, banks today have more access to investors who might provide them with equity funding than in the past. If they have profitable investments, they should be able to fund them with equity like other companies do, even at levels of 15% or 20% or even 25% of assets.

Why do banks hate equity so much and claim such regulations are so costly for them? There are four reasons.

1. Debt overhang – because banks are already indebted, they (meaning their managers and shareholders) prefer debt over equity as a form of funding. This phenomenon is true for every borrower. In a sense, borrowing can be "addictive."[4]
2. The tax code encourages borrowing because of the tax deductibility of interest payments.[5]
3. Flawed fixation on return-on-equity (ROE) or similar measures for compensation. Such compensation encourages excessive risk taking, which does not create value unless someone else bears the downside.[6]
4. The government safety net – implicit and explicit guarantees – makes it possible and attractive to borrow at subsidized rates.[7]

Importantly, none of these reasons represents a cost to society of imposing high equity requirements given that high indebtedness harms the public. The main beneficiaries from excessive borrowing and risk are actually the bankers. Diversified shareholders likely lose.

If banks benefit from subsidies when they borrow, those subsidies come at the expense of taxpayers. Reducing the subsidies with more equity makes the system better for the public, remove distortions that give banks, particularly the largest ones, advantage over smaller banks and other firms in the economy, and saves on the expense of the subsidies. It is perverse to subsidize and encourage banks to take actions that harm us just as it would be to encourage pollution or reckless driving.

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[4] See the paper "Debt overhang and Capital Regulation," whose executive summary is included within the appendix. As we explain, other companies might not be able to continue borrowing, because previous creditors would not allow it, yet banks' creditors feel secure enough because they might be insured, or have collateral, or trust the safety net. This paper discusses adjustments issues.

[5] See Section 4.1 of "Fallacies, Irrelevant Facts and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive," whose executive summary is attached to this document.

[6] See Anat Admati "Beware of Banks' flawed focus on Return on Equity," New York Times, July 25, 2011, and Section 3.2 "Fallacies, Irrelevant Facts and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive," whose executive summary is attached to this document.

[7] Credit rating agencies give uplifts to some banks; research has shown that the value of the guarantees is very large. See Davies, Richard, and Belinda Tracey, "Too Big to Be Efficient? The Impact of Implicit Funding Subsidies on Scale Economies in Banking," Working paper, Bank of England, 2012. Brian Kelly, Hanno Lustig and Stijn Van Nieuwerburgh, "Too-Systemic-to-Fail: What Option Markets Imply about Sector-Wide Government Guarantees." NBER Working Paper 17615. National Bureau of Economic Research, Cambridge, MA, and Andrew Haldane,"Control Rights (and Wrongs)," Wincott Annual Memorial Lecture, Westminster, London, October 24, 2011.

Risk calibration

Basel III continues the quest to find proper "scientific" risk calibration. It tries to address some of the obvious weaknesses that were seen in the crisis. What it fails to recognize is that the entire approach of risk weights is highly problematic. The attempt to fix the regulation with ever more complex rules is based on the illusion that this can be done properly. Regulators should realize the limitations of models and data to capture complex systems.

In fact, while the approach tries hard to be "scientific" in measuring some risks, it entirely ignores some. For example, it does not quite take into account interest rate risk. And there is no way that the models will be based on enough information about the counterparties to be able to predict the dynamics of liquidity breakdowns or what the next crisis might bring. Banks continue to be allowed to use their risk models, and regulators are burdened with having to approve these models, all of which does not quite give confidence that the system can be trusted to protect us. The approach neglects "black swans" or "unknown unknowns."

The risk weights of Basel II actually allowed banks to "innovate" to hide risks from investors and regulators and they made the system more interconnected and more fragile.[8] Concentrating enormous credit risk on AIG did not make the risk go away; it only transfers it to AIG. When the government bailed AIG out, banks did not fact the risk they took by counting on AIG to be able to pay them. Regulators, meanwhile, also ignored the risks building up at AIG.

Basel III uses narrow lessons from the previous crisis by changing some of the ways risk weights are calculated but it continues to trust the models and the approach and it continues to ignore or be unable to treat some risks. If credit rating agencies are not used, do we know that the alternative models would perform better?

A good analogy for capital regulation is speed limits. Think of banks as trucks with different amounts of dangerous cargo. (The most systemic banks are like trucks carrying explosives.) The truck companies might say that there should be no tight speed limit because they have good drivers and fancy risk models. They might argue that low speed limit, or mandated rest breaks, would increase their costs and increase prices for delivery and thus harm the economy. Would we allow them to drive at 80 miles per hours on the basis of their models and assertions? If we try, there will be much outcry after the first major disaster.

[8] See, for example, Martin F. Hellwig, "Capital Regulation after the Crisis: Business as Usual?" Max Planck Institute for Research on Collective Goods, Bonn, 2010, Preprint 2010-31. Many have criticized the risk weight approach, including Sheila Bair and Tom Hoenig.

The financial system was allowed to operate with excessive leverage and a major disaster did occur. Striving for a fancy model should not detract us from the objective of a safe system, particularly when safety can be achieved at little relevant cost. The equivalent of driving at 35 mph and taking reasonable rest break is that banks do not take excessive debt-fueled gambles that endanger the economy. There is absolutely no cost associated with that for society, only benefits.

Lending and capital requirements

It is ironic that the concerns about enhanced capital standards center on their potentially negative impact on lending. Let us not forget that the biggest credit crunch in recent years, a freeze that led to massive intervention by the government and by the Fed, occurred not because banks had too much capital but because they had too little. It is distress and insolvency that leads credit to be constrained. The key to healthy credit markets is well capitalized banks and fewer distortions. The challenge is to get the banks to this point and to maintain the system, preventing the buildup of risks that led to the recent financial crisis.

Whether banks make loans or not depends on their own preferences. Capital regulation does not restrict lending, but distressed banks may avoid making some good loans or make excessively risky investments.

Importantly, the risk weights encourage certain investments and discourage others. They particularly tend to bias against business lending, and they encourage banks to lend to governments and government-related entities such as municipalities, because they assign such low risk weights to such investments. Whenever regulation views investments as less risky than they really are, banks might over invest. Such was the case for mortgage related securities and for Greek debt held by EU banks. The next crisis in US might well come from excessive loans to highly indebted municipalities.

Regulation should strive to put banks in the best position to make the best loans for the economy. It is in making loans to businesses that banks are particularly beneficial to the economy, but that is not always what they find most attractive. Allowing banks to make payouts to their shareholders does not help lending. Regulators can take a more proactive role, particularly in the transition, to encourage responsible lending.

Do different banks and institutions need different regulation?

Quite clearly, the largest and most complex global institutions, those megabanks that are considered too big to fail require particular attention and the strongest regulation. These institutions are truly dangerous for the economy. In my view it is critical that they be immediately banned from making any payouts to their shareholders until a way is found to contain the risk they impose on the rest of the economy and the distortions they create.

The most systemic institutions should have much higher capital requirements, particularly if nothing else is done to control their risk and complexity. Their equity levels should be maintained between 20%-30% equity to total assets. If they are unable to reach these levels in a managed transition, their solvency and viability should be called into question. Note that this does not mean that they should stay at this size. Their current size may well be inefficiently large, and if subsidies are reduced, they might shrink naturally.

It appears that the regulation actually goes to some length to make distinctions between banks of different types. Regulations should be cost effective, and I share the concern about complexity. Among the advantages of very high and relatively crude rules is that they are simpler. They would require vigilance on the part of the regulators, but more on the bigger picture than on numbingly complicated models that cannot quite be trusted.

I do not, however, share the view that the equity requirements are too high for small banks. I find them too low for these banks as well. More than 450 small banks failed since 2008. The deposit insurance system is useful and handled these failures, but banks should still strive to be more on their own and absorb more of their own losses without becoming distressed or failing. The costs of funding and investments should be determined in undistorted markets even in the case of the banking industry. Only then would we know what the efficient size and scope of this important industry is, and only then would it truly serve the economy.

Healthy Banking System in the Goal, Not Profitable Banks
Letter from Banking and Finance Academics
Published in *Financial Times*
November 9, 2010

The Basel III bank-regulation proposals that G20 leaders will discuss fail to eliminate key structural flaws in the current system. Banks' high leverage, and the resulting fragility and systemic risk, contributed to the near collapse of the financial system. Basel III is far from sufficient to protect the system from recurring crises. If a much larger fraction, at least 15%, of banks' total, non-risk-weighted, assets were funded by equity, the social benefits would be substantial. And the social costs would be minimal, if any.

Some claim that requiring more equity lowers the banks' return on equity and increases their overall funding costs. This claim reflects a basic fallacy. Using more equity changes how risk and reward are divided between equity holders and debt holders, but does not by itself affect funding costs.

Tax codes that provide advantages to debt financing over equity encourage banks to borrow too much. It is paradoxical to subsidize debt that generates systemic risk and then regulate to try to limit debt. Debt and equity should at least compete on even terms.

Proposals to impose a bank tax to pay for guarantees are problematic. High leverage encourages excessive risk taking and any guarantees exacerbate this problem. If banks use significantly more equity funding, there will be less risk taking at the expense of creditors or governments.

Debt that converts to equity, so-called "contingent capital," is complex to design and tricky to implement. Increasing equity requirements is simpler and more effective.

The Basel Accords determine required equity levels through a system of risk weights. This system encourages "innovations" to economize on equity, which undermine capital regulation and often add to systemic risk. The proliferation of synthetic AAA securities before the crisis is an example.

Bankers warn that increased equity requirements would restrict lending and impede growth. These warnings are misplaced. First, it is easier for better-capitalized banks, with fewer prior debt commitments hanging over them, to raise funds for new loans. Second, removing biases created by the current risk-weighting system that favor marketable securities would increase banks' incentives to fund traditional loans. Third, the recent subprime-mortgage experience shows that some lending can be bad for welfare and growth. Lending decisions would be improved by higher and more appropriate equity requirements.

If handled properly, the transition to much higher equity requirements can be implemented quickly and would not have adverse effects on the economy. Temporarily restricting bank dividends is an obvious place to start.

Many bankers oppose increased equity requirements, possibly because of a vested interest in the current systems of subsidies and compensation. But the policy goal must be a healthier banking system, rather than high returns for banks' shareholders and managers, with taxpayers picking up losses and economies suffering the fallout.

Ensuring that banks are funded with significantly more equity should be a key element of effective bank regulatory reform. Much more equity funding would permit banks to perform all their useful functions and support growth without endangering the financial system by systemic fragility. It would give banks incentives to take better account of risks they take and reduce their incentives to game the system. And it would sharply reduce the likelihood of crises.

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Global "Level Playing Field" Arguments are Invalid

Anat Admati and Martin Hellwig[1]

Bankers on both sides of the Atlantic are lobbying furiously against stronger regulation. Authorities in different countries are reluctant to strengthen banking regulation as if the crisis never happened. The European Commission even hesitates to fully implement Basel III.

In this debate, many argue that global competition requires a "level playing field." Following this argument, and concerned about the City's competitiveness, the Interim Report of the UK's Independent Commission on Banking avoids proposing tougher regulation for investment banks.

These "level playing field" arguments are invalid. If banks impose costs and risks on a country's economy, the country is better off with regulations that limit those risks and costs even if others are not doing the same.

In the seventies, environmental regulation and reductions in government support for coal and steel required painful adjustments. But overall welfare has been improved by having cleaner rivers, clearer skies and less waste of taxpayer money. The financial industry does not pollute rivers or skies, but in the crisis it caused damage on the order of trillions of dollars, euros and pounds. Public support was needed to avoid even worse. Using taxpayer money to bail out banks is no better than using it to support the coal industry after excessive wage settlements.

The global economy is not a sporting event where a country's athletes are expected to win as many medals as possible, but a system for the exchange of goods and services. In this system, the competitive successes of banks and the competitive failures of firms in other industries are two sides of the same coin as a country exports financial services and imports other products according to its comparative advantage.

In the UK, the rise of the financial sector over the past three decades was accompanied by a decline in manufacturing. This is not a coincidence. Banks are not just in competition in financial services markets. They are also in competition in markets for inputs, most importantly for scarce talent. The highly talented people that they have drawn into the financial sector have not been available to other industries.

For the economy as a whole, the question is not whether banks are successful but where its resources are most usefully employed. Perhaps those sharp minds in investment banking might have become even more productive in innovative biotechnology?

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[1] An edited version o appeared as an op-ed in *Financial Times*, June 3, 2011. Full text version appeared online in "Martin Wolf's Economists' Forum," *FT.com*, June 6, 2011.

The best uses of scarce resources are found through an undistorted market system. Without distortions, a firm's success in the competition for inputs is prima facie evidence that its use of these resources is economically desirable.

However, with externalities such as health effects of pollution, job and income losses from the fallout of the financial crisis, or costs of government subsidies, market functioning is distorted. It is important to correct such distortions by suitable regulation. The elimination of distortions favoring banks will improve the functioning of the market system and enhance economic welfare.

The severity of the crisis was at least partly due to the fact that major financial institutions operated with only 1-3 per cent equity relative to total assets. With such high leverage, solvency concerns arose quickly and impaired refinancing. Had banks been funded with much more equity, the crisis would have been much less severe.

Basel III allows the total equity of banks to be as low as 3% of their total assets, which is dangerously low. A system where banks, including investment banks, are funded with significantly more equity is not only less fragile, but it is healthier, with fewer incentives for excessive risk taking and a lower likelihood of a credit crunch due to overhanging debt. Banks funded with more equity can better generate economically appropriate value and profits by making loans and providing liquidity, while subjecting the economy to fewer unnecessary risks and costs. Arguments based on banks' return-on-equity are fallacious and irrelevant, as are dire predictions for national competitiveness, lending and growth. None of these should enter the debate.

Some argue that stricter regulation would drive banking into the unregulated shadows. By the same argument, we might give up on taxation because we are afraid of the use of tax loopholes. Enforcing financial regulation is a challenge, but this challenge can be met. In the crisis, the most problematic shadow banking activities had actually been sponsored by regulated banks, and would have been within regulatory reach. If national supervisors were willing to use their enforcement powers over activities in their territory, the threat from shadow banking anywhere would be much reduced. This requires political will and determination.

Comments on

Enhanced prudential standards under section 165, and early remediation requirements under section 166 of the Dodd-Frank Act

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Introduction

Our comments will focus primarily on capital requirements. While we believe that liquidity issues are a legitimate concern, liquidity problems often arise, and are most severe and costly, in distress situations when there are concerns about the solvency of a bank or financial entity. Solvency concerns, in turn, are best addressed by reducing excessive leverage and risk in the system. For a variety of reasons discussed below and in attached research, private actors in the banking system have strong incentives to choose excessive leverage that is not only unnecessary, but is harmful to the ability of the system to serve the economy. Since addressing the problem of excessive leverage is in our view the most important and critical concern, we begin by discussing capital requirements and related issues.

Measures of regulatory capital based on accounting numbers, and the use of risk weights to calculate capital ratios, can both mask important systemic risks. Regulatory capital ratios were not informative during the crisis. What matters is meaningful loss absorbency. It is also important to note that critical sources of systemic risk that cannot be easily seen from balance sheets and from regulatory capital ratios are those associated with the interconnectedness of the system and, more specifically, with counterparty risks. We encourage the Fed to pay close attention to this in stress testing, and we view single party exposure limits as potentially useful tools.

After focusing primarily on capital requirements, we will offer at the end of this note some comments on liquidity, stress tests, and position limits. We also attach excerpts from two papers we have written on the subject of capital regulation. These papers, and additional materials, including academic and policy papers and commentary, can be found at http://www.gsb.stanford.edu/news/research/Admati.etal.html .

The critical role of capital regulation, and relevant costs and benefits

Our financial system has become global and greatly interconnected. This means that the distress and even worse the actual default or "failure" of one institution can have severe negative effects on many others through various contagion mechanisms. Some of these are direct effects, which are transmitted through contractual claims to counterparties. Others are less direct but can be just as significant, if not more so. For example, because institutions often make similar

investments, a type of "information contagion" can occur when observed distress in one institution leads to concerns about the decline of asset values in others, and to possible runs and liquidity problems. At the same time "fire sales" can occur in distressed situations when deleveraging multiples are high. This can create downward pressure on prices, and these externalities in asset markets can result in a "deleveraging spiral." All of these systemic risks harm financial stability and can ultimately interfere with the ability of the financial system to support the economy. The biggest credit crunch in recent memory was due to the chain reactions that followed the Lehman bankruptcy in fall 2008. We have seen that these risks are not hypothetical and their consequences can be devastating.

The key to reducing fragility in the financial system is to reduce the likelihood of distress, and the risk of insolvency and default of systemically important financial institutions. High levels of leverage are fundamental to all the mechanisms mentioned above that create fragility. The capital regulations in place before the crisis, which were based on Basel II, allowed the system to become highly leverage and very fragile and proved to be flawed and insufficient. Part of the failure stemmed from requirements not being enforced effectively throughout the system, which allowed leverage and risk to "hide" in off-balance-sheet entities, such as conduits and SIVs. Entities outside the banking system (such as AIG) were used to push risks off the regulated institutions' balance sheets – only to come back in the form of counterparty credit risk that was correlated with the underlying risks that were being "insured." Another significant problem stemmed from unrecognized "tail risk" that led to AAA securities being treated as totally safe when in fact they were not.

The system that was in place to make sure there was sufficient loss-absorbing capacity clearly failed to protect the system and massive intervention was necessary. The models that were used to assess value at risk were fundamentally flawed. In addition, the models that had been used by regulators to justify any of the specific numbers in the regulations were shown to be ill suited for the purpose. Regulatory Tier I and Tier II capital buffers that were not equity did not absorb any losses and proved ineffective.

Basel III recommends a modest increase in capital requirements. While strengthening some definitions and rules, Basel III retains the approach of calibrating capital requirements to risk-weighted assets, with 4.5 % of risk-weighted assets (plus a 2.5% capital buffer) for common equity, 6% for Tier 1 capital and 10% for Tier 1 plus Tier 2 capital.

Bankers claim that the proposed increases in capital requirements are very substantial or even harsh, presenting them in terms of multiples of previous requirements, and arguing that anything higher would have negative consequences. However, 4.5% or even 7% of risk-weighted assets is still very small. The fact that this is a twice or three times the previous requirement for common equity just indicates how low the previous requirement was. As a percentage of total assets, the numbers are even lower. The problem with risk weights should be abundantly clear by now. In the crisis, and even since, the realization of many risks that had been given zero weight in assessing risk weighted assets caused considerable distress and insolvencies.

The new leverage ratio that is introduced in Basel III seeks to reduee reliance on risk weights that are misleading measures of the true risks and that can be manipulated. It requires that equity be at least 3% of total assets. This is extremely low, allowing assets to be more than 30 times the book value of equity. For banks such as UBS, with equity equal to 2.5% of total assets, this leverage ratio would not make much of a difference, and we have seen that this 2.5% of total assets did not provide adequate protection in the crisis.

The fact that Basel III only makes relatively small changes to Basel II and maintains the same approach is of great concern, since systemic risks and system fragility have not been reduced significantly through any other means. We still have several institutions whose failure would be too damaging to be imaginable (the so-called "too big to fail" or "too interconnected to fail" institutions, now called Systemically Important Financial Institutions). If anything, the too-big-to-fail problem seems to have become more severe with the consolidation of some of the large banking institutions that occurred during the crisis. The implicit subsidies created by the implicit, too-big-to-fail guarantees are still present and still lead to enormous moral hazard problems. They distort pricing and incentives and increase the risk to the system. All of this has serious adverse consequences for the entire economy.

Clearly, the issue of what capital requirements are appropriate depends on an understanding of the social costs and benefits of reducing leverage, which includes understanding adjustment costs and implementation issues.

We have carefully examined claims that have been made that there are costs to significant increases in capital requirements. In two papers that are attached, we show that the arguments made that equity is expensive are either flawed or based on confusions between private and social costs. This means that the view that we must "economize" on bank equity and accept a

fragile system is entirely false. When systemic risks and implicit government subsidies create externalities and distortions, it is actually the *excessive leverage* of financial institutions that is "expensive" for the economy, even if debt seems "cheap" and equity seems "expensive" to decision makers in banks. Reducing the leverage of systemic institutions from levels currently discussed to significantly lower levels, *involving even 20% or more equity as fraction of total assets*, will produce significant social benefits at little (if any) social cost. We have seen no well-grounded model or empirical evidence that argues against this.

In the paper "Fallacies, Irrelevant Facts and Myths in the Discussion of Capital Regulation: Why Bank Equity is *Not* Expensive," (last draft March, 2011), we have undertaken an extensive examination of the various arguments that are made to justify the view that equity is "expensive" in any relevant sense in the context of the regulation. We show that the only reason that the funding costs of systemic institutions might increase with higher capital requirements is the loss of subsidies, which would indicate that current funding costs are artificially low and distorted by subsidies, particularly implicit guarantees but also including the tax subsidies to debt funding.

In "Debt Overhang and Capital Regulation," we consider more closely claims that shareholders would be "diluted" if forced to reduce leverage. We show that while there can be a dilution effect as leverage is reduced, it is critically important to understand its source. The source is due to what has come to be called "debt-overhang." As a result of debt overhang, leverage becomes "addictive" through a ratchet effect. Significant inefficiencies can result, particularly in the context of the systemic risk externalities associated with high leverage. Regulation is essential.

The debt overhang effect comes about because, in a highly-leveraged financial institution, much of the downside risk is borne by institution's creditors and by the FDIC and taxpayers, in those cases where creditors are explicitly or implicitly insured. While other parties are exposed to substantial downside risks, the shareholders and managers of the financial institution retain all the benefits of the upside. The dilution of the shareholders' and managers' interests that occurs when leverage is reduced is the direct result of transferring some of the downside risk away from creditors – especially government and the taxpayers where is does not belong – and onto the shareholders and managers where it more properly belongs. In other words, any dilution of existing equity when leverage is reduced comes about *because the*

financial institutions have already placed excessive risk on creditors and taxpayers. Although it is in managers' narrow interest to resist leverage reduction, making sure that adequate equity buffers are established is essential for the system. This is true even though it is not something that incumbent managers would choose to do on their own and will in fact actively resist. The debt overhang effect creates significant social inefficiencies that must be corrected through regulation.

This effect holds even without any subsidies given to debt funding, but it is greatly exacerbated by their presence. Indeed, the cost of borrowing for any highly leveraged corporation would rise or restrictive covenants would be put in place if creditors had to bear the costs and inefficiencies of distress and bankruptcy. This does not seem to be the case for banks, and it is regulators that are charged with making sure that the public is protected from the costs and inefficiencies of high leverage.

In both papers we emphasize that the easiest way to build up capital is by retention of earnings. We consider the recent decision by the Federal Reserve to allow most large U.S. banks to make payouts to shareholders to be misguided and a move in the wrong direction. In our paper on debt overhang we discuss ways in which institutions might choose to reduce leverage. Based on our analysis and considering the current situation, we conclude that preventing cash payouts to shareholders and managers is one of the best ways to facilitate efficient transitions to a much less fragile system.

We will not comment in detail on liquidity regulation except to note that the likelihood of institutions running into liquidity problems would be greatly reduced with more equity funding. It is concern with insolvency and default that creates or exacerbates liquidity problems, and it is *insolvency* (or suspected insolvency) that makes those problems harder and costlier to solve. The lender-of-last-resort function of central banks was specifically designed to help alleviate pure liquidity problems in the absence of solvency concerns.

Chairman Bernanke told the Financial Crisis Inquiry Committee that "If the crisis has a single lesson, it is that the too-big-to-fail problem must be solved." He also emphasized in a recent speech that the vulnerabilities in the system, including high leverage and a lack of effective supervision of shadow market institutions, were critical reasons for the crisis.[1] It is clear

[1] See speech before Russel Sage Foundation and the Century Foundation, April 16, 2012, available at http://www.federalreserve.gov/newsevents/speech/bernanke20120413a.htm

that, despite the resolution authority given FDIC under Title II of Dodd Frank Act, financial markets do not view current regulatory effort as reducing significantly the "too big to fail" problem. Capital requirements can play a critical role in reducing this problem.

It is also critical that capital requirements be designed to give the FDIC the best chance of meeting its mandate to resolve systemically important financial institutions without using taxpayer money. To this end, there must be sufficient loss-absorbing funding for these institutions. Equity is the best source of such funding. In addition to earnings retention, publicly held banks have access to markets where they can issue new shares.

What is the "optimal" level of required capital?

The discussion above suggests that there are large social benefits to greatly reducing the leverage of important financial institutions. We have not seen any valid arguments or compelling evidence suggesting that there are *social* costs to offset the gains that come with significant increases in capital requirements relative to existing or proposed levels.

We are aware of the models that were used to justify the Basel III "numbers," but we find that these are weak and inadequate. For example, they do not capture properly the negative externalities and the distortions created by high leverage. At the same time they make assumptions that clearly exaggerate the social costs of reducing leverage. For example, one of the models that have been used is based on the assumption that higher capital requirements lower the ability of banks to provide deposit-type liabilities to the household sector.[2] Since in this model deposits enter directly into the utility function of households, this creates a purported social cost of higher requirements. However, since deposits are only a fraction of bank liabilities and there are many ways banks could meet higher capital requirements without changing outstanding deposits, this assumption, which is critical to the model, is dubious at best. At the same time, this model assumes that there are no systemic risks and no costs to the economy created by fragility in the financial sector, costs of the sort we witnessed in the last crisis.

[2] See Skander J. Van den Heuvel, The Welfare Cost of Bank Capital Requirements, *Journal of Monetary Economics*, march, 2008

One of the studies attempting to calibrate the precise Basel III requirements states:[3] "The regulatory minimum is the amount of capital needed to be regarded as a viable going concern by creditors and counterparties." By this criterion, capital regulation would not be necessary: A bank that fails this criterion would not be viable because creditors and counterparties would refuse to deal with it. Good regulation should focus on the negative impact that undercapitalized banks impose on the rest of the financial system and on society when they are distressed. It is this external or "polluting" impact that the regulation should seek to limit.

The challenges involved in developing models to assess the costs and benefits of capital requirements lie in the extraordinary complexity of the financial system and the many ways it can adversely affect the rest of the economy. By necessity models must be simplifications, but a good model must have at least the following two characteristics:

- It must capture those risks and other effects that are of first order importance.
- It should not be driven by assumptions that are not at all in accord with the actual world in which we live and do not pass the common sense "smell test."

The models that are used to support the high leverage levels that are permitted under Basel III fail to meet one or both of these criteria.

Basel specifies only *minimum* requirements. If these numbers are deemed too low, any national regulator can choose to set higher requirements. While banks often bring up "level playing field" arguments, and while it is desirable for all regulators to set the same (high) requirements, the failure of others to implement the regulation or to go beyond the Basel minimum should not alter the objective of regulators in the US. *It is not a national priority that US banks are successful in global competition if this exposes US taxpayers to excessive risks and costs.*[4] Regulators in UK, Sweden, Switzerland and Spain, and elsewhere might in fact follow the US lead if it sets higher and better designed capital requirements.

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[3] Basel Committee on Banking Supervision, (2010), "Calibrating regulatory minimum capital requirements and capital buffers: a top-down approach," Discussion Paper 180, http://www.bis.org/publ/bcbs180.pdf

[4] See "Global Level Playing Field Arguments are Invalid" by Anat Admati and Martin Hellwig, Financial Times, June 3, 2011, available here http://www.gsb.stanford.edu/news/research/admati-battle-begun.html

Risk calibration and the flaws in the risk weights approach

Basing capital requirements on risk weights might seem like a sensible way to calibrate requirements to the risk that different investments bring to the banks' balance sheet. However, the risk weight system as implemented in Basel II, and which is essentially maintained as an approach in Basel III, is inherently flawed. It creates distortions, it can exacerbate systemic risk, and it is far too easily manipulated.[5]

We briefly summarize the problems. First, when regulation is based on risk weights, banks often attempt to move some of the major risks off their books. Interest rate swaps, currency swaps, credit default swaps – all can be used to shift the risks from certain positions to third parties. Such developments increase the interconnectedness of the system and raise the danger of contagion effects. The effectiveness of the hedges depends on the counterparties' ability to pay. If, following a shock, the counterparties' ability to pay is impaired, the risk may come right back, now in the form of a counterparty credit risk whose incidence is driven by the very risk that was to be hedged.[6] Prior to the recent crisis, banks tried to hedge the credit risk of mortgage-backed securities through credit default swaps with AIG or with monoline insurers. The bailout of AIG ended up covering for the downside counterparty risk that banks took in those transactions.

Second, the risk weighting system gives incentives to banks to hide both risk and leverage by heavily favoring investments that have relatively low risk weights but are actually exposed to underlying risks that create a risk premium and "enhance" yield and return. A clear recent example can be seen in investments made in AAA securities or in sovereign debt. Many banks ran into trouble in the crisis, and more recently Dexia had to be bailed out even while presenting high regulatory capital. This is because many of the supposedly "safe" but "enhanced" return assets ended up leading to significant losses.

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[5] For a more detailed discussion on the issues see the paper "Capital Regulation after the Crisis: Business as Usual?" by Martin Hellwig, available at
http://www.ucl.ac.uk/economics/seminarpapers/november10/dept03nov10.pdf

[6] An example is provided by Thailand in the crisis of 1997. In the run-up to the crisis, much lending, from foreign banks to Thai banks and from Thai banks to Thai firms, had taken place in dollar terms in order to eliminate exchange rate risks for lenders. After the devaluation of the Baht, however, Thai firms could not pay their dollar debts to Thai banks, and, with their debtors in default, Thai banks could not pay their dollar debts to foreign banks.

Third, the system of risk weights can lead to distortions. We have seen, both before the financial crisis and currently in Europe, that banks may find traditional business lending less attractive than trading securities and other types of investments. To the extent that this is driven by the rather arbitrary risk weights assigned to various investments and does not reflect the underlying economic and social value associated with them, this results in a clear distortion and social loss.

Conflicted incentives and the gap between private and social considerations

Bank managers have incentives to increase leverage and risks because debt funding is subsidized relative to equity, and because their compensation, which is either directly or indirectly tie to ROE (return on equity), often encourages leverage and risk. Their perspective with respect to leverage and risk is also colored by debt overhang, as explained above. Since the choices made by market participants do not fully account for the systemic effects of their actions, these choices can be socially inefficient. Capital regulation is of critical importance in correcting the resulting distortions.

Quite unfortunately, the tax code also encourages the use of debt funding over equity. Since leverage exacerbates systemic risk and thus creates a negative externality, this is a perverse effect. The tax treatment of debt relative to equity creates a strong divergence between banks' preferences regarding their funding and what is good for the public. This presents even more of a challenge for banking regulation and supervision. It would be highly desirable that tax codes change to equalize the treatment of equity relative to debt funding.

We realize that tax policy is not controlled by the Federal Reserve. However, it would be useful for the Fed to clarify this issue and to call on policy makers to change the distortion associated with subsidizing debt funding through tax policy. This issue is broader than banking, but because leverage is so high and so damaging in banking, this tax distortion is particularly severe in this sector. It is, however, critical to recognize that, other than the distortions that they create, taxes are not *per se* a social cost. Thus, if even banks were to pay more taxes as a result of increased capital requirements, this does not constitute a social cost of the requirement.

As suggested above, compensation structures in banking, which often depend on short-term performance and on measures that encourage risk taking, are an issue. The incentives that such compensation structures create can exacerbate systemic risk. It would be desirable that at

least some cash payments in banking are deferred and can be clawed back if losses that harm the bank and the economy occur.

Comments on stress testing

The Fed relies on periodic stress tests to determine whether banks are sufficiently well capitalized and whether they should be authorized to make distributions to shareholders in the form of dividends and share buybacks. While stress tests can provide useful information, we urge extreme caution in trusting the results and in allowing payouts to equity in the near future. Projections of credit risks and future losses under certain scenarios invariably involve the use of models and assumptions. We have seen very clearly the limitations of models and the possibility that assumptions prove wrong when it is too late. The regulatory capital of many institutions seemed adequate around the time of the financial crisis. As mentioned above, even Dexia, shortly before it had to be bailed out and nationalized last summer, seemed to have had substantial regulatory capital.

We would also like to flag the differences between netting conventions under GAAP in the US and under International Financial Reporting Standards (IFRS). Stress testing and single counterparty regulation might be useful in addressing the critical issue of counterparty risk. It is important that any scenario analysis or stress test take seriously the actual exposure to counterparty risks. Even if netting is allowed under GAAP, if a counterparty default does not void a liability for a covered entity, this can increase the risk to the entity and to the system.

As argued above, there are no social costs associated with additional bank equity that are anywhere near in magnitude to the social benefits of significantly reducing leverage. It is therefore ill advised to deplete capital on the basis of stress tests at a time when so much uncertainty looms in Europe and when many uncertainties remain with respect to existing loans and other assets held by financial institutions. The risk and cost to financial stability is significant, and there is no social benefit associated with the depletion of capital, only costs. Instead of making equity payouts, banks could either make prudent investments with the earnings or reduce their debt.

Comments on single counterparty exposure limits

The dangerous interconnectedness in the financial system manifests itself in so-called counterparty risks, which leads to the contagion that causes cascading effects from the distress or default of one entity to the entire system. It would be alarming if the default of any counterparty could wipe out 10% of the loss absorbing capital of a systemically important financial institution. This is particularly so if such a default might be correlated with the distress of others in the system, such as in a financial crisis.

We note that the exposure limit is specified as a ratio of total exposure relative to regulatory capital. If covered companies had more equity, and thus more regulatory capital, this requirement would be less onerous. Even at current levels of capital, however, it is hard to imagine a legitimate reason, from a regulatory perspective, for a systemically important institution to have such exposure to unaffiliated entities that 10% of its capital would be put at risk. This exposes the entity and the system to unnecessary risk. To the extent that banks find the single counterparty position limit onerous, this should only alarm us with respect to the great interconnectedness of the system.[7]

Comments on liquidity requirements

With respect to liquidity regulation, we wish to offer the following comments. First "liquidity" is a property that pertains to certain asset markets and to certain assets at certain times.[8] It is not a fixed property and it may change quickly. As we saw in August 2007, certain markets and assets can be highly liquid one day and highly illiquid the next. This variability over time poses a challenge for any system of liquidity management, whether from the perspective of the bank or from the perspective of the regulator.

Some assets are liquid even though they have long economic lifetimes, because there is a well functioning market for them. This would typically be true of a Treasury bond or many of the stocks traded on exchanges. As for private debt, we have seen that, for some debt-like securities, markets can turn from being highly liquid to being completely illiquid in a matter of days if not hours. Similar issues arise with respect to short-term debt, including repo and asset-backed

[7] The comment letter by the Clearing House submitted for this regulation on April 27, 2012 actually provides evidence of dangerously large exposures that should be a concern.

[8] Hicks (1935): An asset is liquid if there is little uncertainty as to its being realizable at short notice without loss.

securities. The debtor's ability to repay this debt may change from one day to the next, due to a run by (other) creditors or to a freeze in the markets for the assets that the debtor holds.

Given the fluidity of "liquidity" as a property of assets, any attempt to regulate liquidity coverage is fraught with a risk that liquidity may disappear precisely when it is needed. This could be avoided if the regulation restricted banks to holding cash and short-term treasuries only for liquidity coverage.[9]

Whereas liquidity requirements can affect the assets the banks hold, capital requirements do not. They only affect the way in which banks fund their investments. If banks are required to fund with more equity, they have better loss absorbency and better incentives to avoid unconscionable risks. If banks have more funding by equity, market participants will also be less worried about the possibility of insolvency and will be more willing to provide banks with liquidity if needed. In a very real sense, therefore, effective capital requirements contribute to improving the banks' liquidity.

In summary, effective, well designed capital requirements provide a powerful tool, and are the most cost-effective approach, for creating a healthier, safer, and less distorted banking system.

[9] Holding these assets could be costly to extent that the amount paid for the liquidity provided by these assets is excessive to the need.

Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is *Not* Expensive

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Full paper available at

http://www.gsb.stanford.edu/news/research/Admati.etal.html

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Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is *Not* Expensive

Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig, and Paul Pfleiderer

Abstract

We examine the pervasive view that "equity is expensive," which leads to claims that high capital requirements are costly and would affect credit markets adversely. We find that arguments made to support this view are either fallacious, irrelevant, or very weak. For example, the return on equity contains a risk premium that *must* go down if banks have more equity. It is thus incorrect to assume that the required return on equity remains fixed as capital requirements increase. It is also incorrect to translate higher taxes paid by banks to a *social* cost. Policies that subsidize debt and indirectly penalize equity through taxes and implicit guarantees are distortive. Any desirable public subsidies to banks' activities should be given directly and not in ways that encourage leverage. And while debt's informational insensitivity may provide valuable liquidity, increased capital (and reduced leverage) can *enhance* this benefit. Finally, suggestions that high leverage serves a necessary disciplining role are based on inadequate theory lacking empirical support.

We conclude that bank equity is *not* socially expensive, and that high leverage is not necessary for banks to perform *all* their socially valuable functions, including lending, deposit-taking and issuing money-like securities. To the contrary, better capitalized banks suffer fewer distortions in lending decisions and would perform better. The fact that banks choose high leverage does not imply that this is socially optimal, and, except for government subsidies and viewed from an *ex ante* perspective, high leverage may not even be privately optimal for banks.

Setting equity requirements significantly higher than the levels currently proposed would entail large social benefits and minimal, if any, social costs. Approaches based on equity dominate alternatives, including contingent capital. To achieve better capitalization quickly and efficiently and prevent disruption to lending, regulators must actively control equity payouts and issuance. If remaining challenges are addressed, capital regulation can be a powerful tool for enhancing the role of banks in the economy.

Keywords: capital regulation, financial institutions, capital structure, "too big to fail," systemic risk, bank equity, contingent capital, Basel, market discipline.

JEL classifications: G21, G28, G32, G38, H81, K23.

Executive Summary

There is a pervasive sense in discussions of bank capital regulation that "equity is expensive" and that higher equity requirements, while beneficial, also entail a significant cost. The arguments we examine, which represent those most often made in this context, are fallacious, irrelevant, or very weak. Our analysis leads us to conclude that requiring that banking institutions are funded with *significantly* more equity entails large social benefits and minimal, if any, social costs. We list below some of the arguments made against high equity requirements and explain why they are either incorrect or unsupported.

Some common arguments made against significantly increasing equity requirements:

- *Increased equity requirements would force banks to "set aside" or "hold in reserve" funds that can otherwise be used for lending.* This argument confuses capital requirements with liquidity or reserve requirements. Capital requirements refer to how banks are funded and in particular the mix between debt and equity on the balance sheet of the banks. There is no sense in which capital is "set aside." Liquidity or reserve requirements relate to the *type* of assets and asset mix banks must hold. Since they address different sides of the balance sheet, there is no immediate relation between liquidity requirements and capital requirements.

- *Increased equity requirements would increase banks' funding costs because equity requires a higher return than debt.* This argument is fallacious, because the required return on equity, which includes a risk premium, must decline when more equity is used. Any argument or analysis that holds fixed the required return on equity when evaluating changes in equity capital requirements is fundamentally flawed.

- *Increased equity requirements would lower the banks' Return on Equity (ROE), and this means a loss in value.* This argument is also fallacious. The expected ROE of a bank increases with leverage and would thus indeed decline if leverage is reduced. This change only compensates for the change in the risk borne by equity holders and does not mean that shareholder value is lost or gained, except possibly if increased leverage brings more government subsidies.

- *Increased equity requirements would increase banks' funding costs because banks would not be able to borrow at the favorable rates created by tax shields and other subsidies.* It is true that, through taxes and underpriced explicit or implicit guarantees, debt financing is subsidized and equity financing is effectively penalized. Policies that encourage high leverage are distorting and paradoxical, because high leverage is a source of systemic risk. The subsidies come from public funds. If some activities performed by banks are worthy of public support, subsidies should be given in ways that do not lead to excessive leverage.

- *Increased equity requirements would be costly since debt is necessary for providing "market discipline" to bank managers.* While there are theoretical models that show that debt can sometimes play a disciplining role, arguments against increasing equity requirements that are

based on this notion are very weak. First, high leverage actually *creates* many frictions. In particular, it creates incentives for banks to take excessive risk. Any purported benefits produced by debt in disciplining managers must be measured against frictions created by debt. Second, the notion that debt plays a disciplining role is contradicted by the events of the last decade, which include both a dramatic increase in bank leverage (and risk) and the financial crisis itself. There is little or no evidence that banks' debt holders provided any significant discipline during this period. Third, many models that are designed to attribute to debt a positive disciplining role completely ignore the potential disciplining role that can be played by equity or through alternative governance mechanisms. Fourth, the supposed discipline provided by debt generally relies upon a fragile capital structure funded by short term debt that must be frequently renewed. Whereas capital regulation is intended to reduce fragility, fragility is a necessary by-product of the purported disciplining mechanism. Finally, one must ask if there are no less costly ways to solve governance problems.

- *Increased equity requirements would force or cause banks to cut back on lending and/or other socially valuable activities.* First, higher equity capital requirements do not mechanically limit banks' activities, including lending, deposits taking and the issuance of liquid money-like, informationally-insensitive securities. Banks can maintain all their existing assets and liabilities and reduce leverage through equity issuance and the expansion of their balance sheets. To the extent that equity issuance improves the position of existing creditors and/or it may be interpreted as a negative signal on the bank's health, banks might privately prefer to pass up lending opportunities if they must fund them with equity. The "debt overhang" problem can be alleviated if regulators require undercapitalized banks to recapitalize quickly by restricting equity payouts and mandating new equity issuance. Once better capitalized, banks would make better lending and investment decisions and issuance costs would be reduced.

- *The fact that banks tend to fund themselves primarily with debt and have high levels of leverage implies that this is the optimal way to fund bank activities.* It does not follow that just because financial institutions choose high leverage, this form of financing is privately or socially optimal. Instead, this observed behavior is the result of factors unrelated to social concerns, such as tax incentives and other subsidies, and to frictions associated with conflicts of interests and inability to commit in advance to certain investment and financing decisions.

- *High equity requirements will drive banking activities from regulated to unregulated sectors and would thus be ineffective or even harmful.* First, in the run-up to the crisis, many activities and entities in the so-called "shadow banking system" relied on credit backstops and other commitments made by *regulated* entities. Thus, these activities and entities were, and continue to be, within regulators' reach. Second, defining on a continual basis the entities and activities that should be regulated will always be a challenge. It is far from clear that, given the tools already, and potentially, available to lawmakers and regulators, the challenge of effective capital regulation cannot be met.

Recommendations

- *Since, as we have argued, bank equity is not expensive, regulators should use equity requirements as a powerful, effective, and flexible tool with which to maintain the health and stability of the financial system.* High leverage is *not* required in order for banks to perform all their socially valuable functions, such as providing credit and creating liquid securities. Not only does high leverage create fragility and systemic risk, it is in fact leads to distorted lending decisions.

- *Regulators should use restrictions on equity payouts and mandate equity issuance to help banks, and to assure that they maintain adequate and high equity capitalization.* If this presents a governance problem, such problems can be solved with the help of regulators. Prohibiting, for a period of time and for all banks, any dividends and other equity payouts, and possibly imposing equity issuance on a pre-specified schedule, is an efficient way to help banks build their equity capital quickly and efficiently without leading to the contraction of credit. If done under the force of regulation, withholding payouts or issuing additional equity would not lead to negative inferences about the health of any particular bank. It would also alleviate the debt overhang distortion that might lead banks to reduce lending.

- *If certain activities of the banking sector are deemed to require subsidies, then subsidies should be given in ways that alleviate market frictions and not through a system that encourages high leverage.* Tax shields and implicit government guarantees subsidize debt finance and thus create a wedge between the private incentives of the banks and social concerns. This policy is undesirable given the systemic risk and additional frictions brought about by high leverage.

- *Better resolution procedures for distressed financial institutions, while necessary, should not be viewed as alternatives to having significantly better capitalized banks.* Since such procedures are not likely to eliminate the cost of financial distress, reducing the likelihood that a resolution procedure is needed is clearly important, and higher equity requirements are the most effective way to do so.

- *Higher equity requirements are superior to attempts to fund bailouts through a "bailout fund" supported by bank taxes.* While charging banks upfront could potentially remove the subsidy associated with bailouts, failure to properly adjust the tax to the risk of individual banks could create significant distortions, particularly excessive risk taking. Equity requirements, as a form of self-insurance where the bank backs up its liabilities more directly, would be priced by financial markets and be more effective in reducing the need for government intervention.

- *Approaches based on equity are superior to those that rely on non-equity securities such as long term debt or contingent capital to be considered part of capital regulation.* Contingent capital, and related "bail-in" proposals, where debt is converted to equity when a trigger event occurs, are complicated to design and present many implementation issues. There is no compelling reason that the "debt-like" feature of contingent capital has social value. Simple approaches based on equity are more effective and would provide more reliable cushions.

Table 2: Summary of Reasons and Critiques

"Reasons" given for why increased equity capital requirements would be costly	**Is the statement true?**	**Would this "reason" give incentives to bank managers to object to increased capital requirements?**	**Would this "reason" give incentives to bank shareholders to object to increased capital requirements?**	**From a public policy perspective, is this a legitimate reason for not significantly increasing capital requirements?**
Increased equity requirements would prevent banks from operating at the optimal scale.	No. Equity can be added to the balance sheet without changing the bank's core business.	It should not, because it is false.	It should not, because it is false.	No! It is false.
Increased equity requirements reduce the average ROE (Return on Equity) for banks.	Generally Yes.	Yes if compensation depends on ROE.	It should not, because risk is reduced and the value of equity would not change.	No! This is irrelevant to value creation.
Increased equity requirements would increase banks' total funding costs, because banks would be forced to use more equity, which has a higher required rate of return.	No. Changing the capital structure changes how risk is distributed but not the overall cost of funding.	It should not, because it is false.	It should not, because it is false.	No! It is false!
Increased equity requirements would decrease the size of the interest tax shields banks can obtain through debt financing.	Yes.	Perhaps, but this depends on their compensation and preferences.	Yes, because shareholders benefit from subsidies.	No! Tax shields subsidize the use of debt, but it makes no sense to encourage leverage since it generates negative externalities and distortions.
Increased equity requirements reduce banks' ability to use cheap debt financing that is subsidized by implicit government guarantees.	Yes.	Yes if compensation is related to equity value.	Yes, because shareholders benefit from subsidies.	No! Guarantees subsidize the use of debt, but it makes no sense to encourage leverage since it generates negative externalities and distortions.
Increased equity requirements would reduce managerial discipline and thus interfere with effective governance.	Very unlikely to be true.	No.	It should not, because there are alternative ways to create effective governance.	No! Claims that debt disciplines managers are not supported by adequate theories or by empirical evidence.
Increased equity requirements would lead banks to restrict lending if they perceive their equity to be under-valued.	Possibly true.	Perhaps.	Perhaps.	No! Better capitalized banks have more retained earnings for lending; any negative impact of equity issuance or payout restrictions can be mitigated by reducing banks' discretion.

Debt Overhang and Capital Regulation

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March 23, 2012

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Debt Overhang and Capital Regulation

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Abstract

We analyze shareholders' incentives to change the leverage of a firm that has already borrowed substantially. As a result of debt overhang, shareholders have incentives to resist reductions in leverage that make the remaining debt safer. This resistance is present even without any government subsidies of debt, but it is exacerbated by such subsidies.

Our analysis is relevant to the debate on bank capital regulation, and complements Admati et al. (2010). In that paper we argued that subsidies that favor debt over equity are the key reason that banks funding costs would be lower if they "economize" on equity. Subsidies come from public funds, and reducing them does not represent a *social* cost. It is thus irrelevant for assessing regulation. Other arguments made to support claims that "equity is expensive" are flawed.

Like reduction in subsidies, the effects of leverage reduction on bank managers or shareholders do not represent a social cost. In fact, we show that debt overhang creates inefficiency, since shareholders would resist recapitalization even when this would increase the combined value of the firm to shareholders and creditors. Moreover, debt overhang creates an "addiction" to leverage through a ratchet effect. In the presence of government guarantees, the inefficiencies of excessive leverage are not fully reflected in banks' borrowing costs.

Since banks' high leverage is a source of systemic risks and imposes costs on the public, resistance to leverage reduction leads to *social* inefficiencies. The main beneficiaries from high leverage may be bank managers. The majority of the banks' shareholders, who hold diversified portfolios and who are part of the public, are likely to be net losers. Our analysis highlights the critical importance of effective capital regulation and high equity requirements, especially for large and "systemic" financial institutions.

We analyze shareholders' preferences when choosing among various ways leverage can be reduced. We show that, with homogeneous assets, if the firm's security and asset trades have zero NPV, and the firm has a single class of debt outstanding, then shareholders find it equally undesirable to deleverage through asset sales, pure recapitalization, or asset expansion with new equity. When these conditions are not met, shareholders can have strong preferences for one approach over another. For example, if the firm can buy back junior debt, asset sales are the preferred way to reduce leverage. This preference for asset sales, or "deleveraging," can persist even if such sales are inefficient and reduce the total value of the firm.

Keywords: capital regulation, financial institutions, capital structure, "too big to fail," systemic risk, bank equity, debt overhang, underinvestment, recapitalization, deleveraging, bankruptcy costs, Basel.

JEL classifications: G21, G28, G32, G38, H81, K23.

A Non-Technical Summary of Results and Policy Implications

In a previous paper entitled "Fallacies, Irrelevant Facts and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive," we reviewed arguments claiming that substantial increases in capital requirements would be costly for the economy.[1] In the context that is relevant to regulation, we showed that these arguments are invalid. Some of them rest on confusions about how debt and equity are priced in financial markets. Others involve confusing the bank's private costs, which are distorted by government subsidies to debt, with the true economic costs that are relevant for the economy.

The high leverage of large financial institutions imposes significant negative externalities by increasing the fragility of the financial system. However, given subsidies to debt funding, and a (flawed) focus on raw return on equity, banks have incentives to maintain excessive leverage.

Summary of Results

In this paper we show that, due to the effect of debt overhang, shareholders and managers of highly leveraged banks would not find it in their interest to reduce leverage. Leverage reduction benefits existing creditors and anyone providing guarantees to the debt. Resistance to leverage reduction can persist even if the total value of the bank might increase, thus creating an inefficiency. This inefficiency does not depend on the presence of debt subsidies. Rather, it involves a fundamental conflict of interests between incumbent shareholders on the one hand and debt holders and possibly taxpayers on the other.

When high leverage imposes negative externalities on third parties, the resistance to leverage reduction creates social inefficiencies. In the banking regulation context, in fact, the main beneficiaries may be bank managers. The majority of the banks' shareholders, who hold diversified portfolios and who are taxpayers and part of the public, are likely to be net losers.

For all firms, debt overhang effect creates an "addiction" to leverage through a ratchet effect. In the presence of debt overhang, shareholders would not voluntarily reduce leverage even when this would increase the total value of the firm. By contrast, shareholders may choose to *increase* leverage if they can legally do so. In the absence of government guarantees, these inefficient distortions and conflicts might be mitigated through covenants in debt contracts. Inefficiencies that could not be addressed in this way would be reflected in the cost of borrowing. With government guarantees, however, debt holders have fewer incentives to address these problems through covenants, and the inefficiencies associated with excessive leverage are not fully reflected in the cost of debt.

We examine three ways a bank can reduce its leverage. Pure recapitalization involves buying back debt using new equity, without changing the assets held by the bank. Alternatively, leverage can be reduced by selling assets and using the proceeds to buy back debt ("deleveraging"), or by issuing new equity and acquiring new assets. We show that under some conditions, shareholders are indifferent among these approaches to reducing leverage; all are equally undesirable. For example, if there is one class of debt, and asset sales or purchases do not, by themselves, generate value or change the risk of the assets,

[1] In banking jargon the misleading phrase "hold more capital" is often used instead of the much more accurate "funding with more equity." This misleading phrase leads many to believe that "holding" capital is similar to holding idle reserves. Nothing could be further from the truth, since capital (equity) concerns how assets are funded, not what assets are held.

then all three approaches to leverage reduction lead to the same loss for shareholders. Asset sales, however, are the preferred way to reduce leverage in a number of situations. One example is when there are multiple classes of debt and shareholders can repurchase the most junior classes. In this case, debt buybacks financed by asset sales create a wealth transfer from senior debt holders to shareholders. Such preference for "deleveraging" can persist even if such sales are inefficient and reduce the total value of the bank to its investors and to the economy.

Policy Implications

Debt overhang creates distorted incentives and conflicts of interests with respect to reductions in leverage. Specifically, bank managers have incentives to make decisions that are in direct conflict with creditors and the public, and which may not even be in the combined interest of the banks' investors. This highlights the critical importance of regulation.

The harmful effects of debt overhang, which can include reduction in lending when banks are distressed, are created by high leverage. The inefficiencies can be reduced if banks are funded with significantly more equity on a regular basis. This calls for much higher equity requirements. This is particularly important for large banks that are "systemic," because market participants would not address the inefficiencies in the presence of government guarantees.

The analysis in this paper reinforces the conclusions of our previous paper that equity requirements significantly higher than those currently considered would provide large social benefits at little if any social cost. The studies that have been put forth to support the specific Basel III "numbers" are flawed. For example, by treating the required return on equity as fixed, or neglecting the inefficiencies, distortions and externalities that high leverage generates, the studies over-estimate the cost of equity requirements and ignore some of their benefits.

If banks "deleverage" through asset sales, or avoid making loans due to debt overhang, lending may be reduced inefficiently. If this is a concern, regulators should limit banks' discretion. Rather than targeting a *ratio,* the focus should be on restricting payouts that deplete equity, and possibly mandating specific amounts of new equity, e.g., through rights offering. Such actions would make sure banks have sufficient funds to make worthy loans even as they become better capitalized.[2]

Conflicts of interests similar to those analyzed here give incentives to bank managers to make large cash payouts such as dividends and share buybacks that maintain high leverage and harm creditors and the public. Cash paid to shareholders or managers is no longer available to pay creditors. European countries whose banks are clearly in distress should have banned such payouts long ago. Similarly, recent decisions by the Federal Reserve to allow most large US banks to increase their payouts before even reaching Basel III levels were misguided. Some of these banks face significant risks and would impose large costs on the economy if they became distressed. By contrast, a useful approach was recently used by the Bank of England's Financial Stability Committee, which pressed UK banks to issue new equity in order to pay bonuses to executive, rather than using cash.

[2] Our discussion does not distinguish assets by their contribution to risk and focuses on leverage measured as equity to total assets. The impact of capital requirements can be distorted by the use of risk weights that bias banks' decisions away from traditional lending and create other risks. For example, bank managers compensated on the basis of ROE have strong incentives to bias their investments away from lending and towards risky investments such as sovereign debt that have low regulatory risk weights but have a higher yield to compensate for their actual risk.

WRITTEN TESTIMONY
OF
TERRENCE A. DUFFY
EXECUTIVE CHAIRMAN and PRESIDENT
CME GROUP INC.
BEFORE THE
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT SUB-COMMITTEE AND THE INSURANCE, HOUSING AND COMMUNITY OPPORTUNITY SUB-COMMITTEE
November 29, 2012

Chairwoman Capito, Ranking Member Maloney, Chairwoman Biggert and Ranking Member Gutierrez thank you for the opportunity to testify on the Federal Reserve Board, FDIC and OCC regulatory capital rules implementing the Basel III Interim Capital Framework. I am Terry Duffy, Executive Chairman and President of CME Group, whose clearing house division of the Chicago Mercantile Exchange Inc. ("CME or CME clearing") is among the largest central counterparty ("CCP" or "clearing house") clearing services in the world.[1] CME provides clearing and settlement services for exchange-traded contracts as well as for over-the-counter ("OTC") derivatives. In 2011, CME processed and cleared approximately 3.4 billion contracts. In its capacity as a clearing house, CME is

[1] CME Group Inc. is the holding company for four exchanges, CME, the Board of Trade of the City of Chicago Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges"). The CME Group Exchanges offer a wide range of benchmark products across all major asset classes, including derivatives based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. The CME Group Exchanges serve the hedging, risk management, and trading needs of our global customer base by facilitating transactions through the CME Group Globex electronic trading platform, our open outcry trading facilities in New York and Chicago, and through privately negotiated transactions subject to exchange rules.

registered with the Commodity Futures Trading Commission as a derivatives clearing organization ("DCO") and also has status as a Financial Services Authority Recognized Overseas Clearing House. In July 2012, CME was designated as a systemically important Financial Market Utility under Title VIII of Dodd-Frank.

CME Group applauds the Federal Reserve Board, FDIC and OCC for deferring the final capital rules implementing the Basel III (BSCS 227) Interim Capital Framework. Both Dodd-Frank and the G-20 mandates aim to reduce systemic risk and increase transparency. Our concern is that Basel III's "one size fits all" rules for capital charges based on the risk of cleared derivatives is at odds with these objectives.

The Basel interim framework treats all cleared derivatives as if they require margin to cover a five day period of risk. This means that highly liquid derivatives contracts that trade by means of a central limit order book and that may be quickly and efficiently liquidated without substantial risk are put into the same category as OTC contracts that are not liquid or transparently traded. This blanket categorization is unrealistic and market distorting. Derivatives clearing houses recognize this distinction and require margin levels based on periods of risk that are justified by the actual risks inherent in liquidating the positions. In the U.S.

this means one or two day periods of risk for futures and five day period of risk for less liquid swaps. The failure to base capital charges on properly measured risk may have the unintended consequence of encouraging the use of higher risk instruments. This is inconsistent with both Dodd-Frank and the G-20 policy goal to reduce risks in derivatives trading by moving from opaque to transparent markets.

If the capital rules for bank holding companies diverge from the prudential rules at the clearing level for Broker-Dealer/FCM subsidiaries, consequential market distortions will follow. If clearing houses properly set margins for liquid derivatives to cover a one day risk period while banking regulators impose a capital charge based on five days, banks and their affiliated brokers, will be required to take a capital charge measured by the difference between the prudential clearing level margin for futures and the presumptive Basel III five day period of risk margin. The cost of the capital will be passed on to customers trading liquid products in the form of a demand for higher collateral or higher fees. Once again, contrary to Dodd-Frank. This may distort customers' product choices. Customers may move away from trading liquid exchange traded derivatives. There is a potential that central limit order book exchange-traded products could be more

expensive. The last thing we want to do is drive customers back into an opaque OTC market because of a "one size fits all" margin period.

Basel III's "one size fits all" margin period of risk is also inconsistent with international standards, e.g., CPSS-IOSCO Principles for Financial Market Infrastructures followed by the CME and other qualified CCPs. Those standards recognize that margin levels should correspond to risk and liquidity profiles, and unique attributes of each product and market, and that margin periods of risk will vary among products based on these differing characteristics.

Liquid central limit order book-traded and cleared derivatives, unlike OTC swaps, are standardized, have transparent pricing, and trade in deep liquid markets. They turn over almost 10 times more frequently than OTC swaps. Those characteristics permit rapid offset, liquidation or hedging in the event of an emergency. Broad participation within the exchange-traded derivatives market further demonstrates efficient position and risk management in these events. For example, following the bankruptcy of Lehman Brothers Inc. in 2008, CME took control of Lehman's proprietary positions and liquidated the portfolio the same day, with a liquidation value well within the portfolio's $2.3 billion margin requirement.

CME also maintains extensive historical price data that further demonstrates the adequacy of data used in establishing margin levels and the appropriate exposure period to capture. For instance, we maintain price data for some of the most liquid exchange traded products dating back to 1982 for the first S&P 500 index contract, 1981 for Eurodollar futures, and 1977 for the first Treasury bond futures contract.

There is no risk management benefit to banks, their affiliated brokers, or the financial system by imposing capital charges on them beyond the clearing level margin period of risk established for these liquid contracts.

CME Group has expressed these concerns in the comments filed during the Agencies rule-making[2], in discussions with Federal Reserve Board staff, and in a joint letter to the Financial Stability Board, the Basel Committee on Banking Supervision and other standard setters from CME and 11 other exchanges located

[2] See attached letter to OCC, FED and FDIC dated October 22, 2012

Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements (OCC Docket ID OCC-2012-0009;FRB Docket No. R-1442; FDIC RIN 3064-AD96)

Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule (OCC Docket ID OCC-2012-0010;FRB Docket No. R-1442;FDIC RIN 3064-AD97)

in each of the Americas, EMEA and APAC.[3] The World Federation of Exchanges has also raised concerns in a separate letter to them.[4]

The Agencies capital rules should be amended to eliminate the addition of four days of capital on top of one day margin for exchange traded derivatives. It should be replaced with an approach consistent with the CPSS-IOSCO Principles recognizing that adequate margin periods vary and will be set based on the liquidity, transparency and other risk-reducing characteristics of each product and market.

Thank you for the opportunity to appear before you today.

[3] See attached Joint Letter to FSB, BCBS, CGFS and CPSS dated November 27, 2012

[4] See attached WFE letter dated November 27, 2012.

CME Group

VIA E-MAIL

October 22, 2012

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Re: Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements (OCC Docket ID OCC-2012-0009; FRB Docket No. R–1442; FDIC RIN 3064–AD96)
Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule (OCC Docket ID OCC-2012-0010; FRB Docket No. R–1442; FDIC RIN 3064–AD97)

Ladies and Gentlemen:

CME Group Inc. ("CME Group"), on behalf of the Chicago Mercantile Exchange Inc. ("CME Inc.") clearing house division ("CME Clearing" or "CME") appreciates the opportunity to comment on the proposed regulatory capital rules that the Office of the Comptroller of the Currency ("OCC"), Board of Governors of the Federal Reserve System ("Board"), and Federal Deposit Insurance Corporation ("FDIC") (collectively, the "Agencies") published in several notices of proposed rulemakings ("NPRs") in the Federal Register on August 30, 2012. CME is among the largest central counterparty ("CCP") clearing services in the world. CME provides clearing and settlement services for exchange-traded contracts as well as for over-the-counter ("OTC") derivatives.[1] In 2011, CME processed and cleared approximately 3.4

[1] CME's parent company (CME Group Inc.) operates four separate exchanges, including CME, the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges"). The CME Group Exchanges offer a wide range of benchmark products across all

billion contracts, averaging 13.4 million contracts per day. In its capacity as a CCP, CME is registered with the Commodity Futures Trading Commission ("CFTC") as a derivatives clearing organization ("DCO") and also has status as a Financial Services Authority Recognized Overseas Clearing House.

On July 18, 2012, the Financial Stability Oversight Council designated CME Inc. as a systemically important financial market utility ("designated FMU") under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Provisions within section 805 of the Dodd-Frank Act, enacted by the Board through Regulation HH Designated Financial Market Utilities ("Regulation HH"), require the Board to promulgate risk management standards for designated FMUs. Regulation HH grants authority to the CFTC to act as CME's designated Supervisory Agency and prescribe regulations that integrate the CPSS-IOSCO Principles for Financial Market Infrastructures ("PFMIs") and existing prudential requirements when designing risk management standards. To recognize the systemic protections and robustness of designated FMUs who adhere to the PFMIs ("Qualified CCP" or "QCCP"), the NPRs invite capital incentives for exposures to a Qualified CCP relative to a non-Qualified CCP.

This response focuses on certain elements of the proposed capital framework that stand to motivate and influence the expansion of central counterparty clearing for derivatives. Bank capitalization requirements are a critical and fundamental element of the overall financial regulatory system. Consequently, the decisions of the Agencies concerning the capitalization framework will have a material impact on the evolution of central clearing. We believe it is particularly important that CME and other CCPs provide meaningful feedback to the Agencies at a time when crucial decisions over the future of financial regulation are being formulated.

CME recognizes the Agencies have largely adopted international capital standards proposed by Basel Committee on Banking Supervision ("BCBS"). CME actively participated in each consultative process administered by the BCBS related to *Capital requirements for bank exposures to central counterparties*. Within our responses[2] we advocated for a framework that assures greater transparency, safety and efficiency in the global financial markets and encourages greater utilization of CCPs by market participants. However, we also raised several fundamental concerns related to the capitalization of exposures to CCPs that we believe will critically influence the migration towards central clearing.

To efficiently implement the objectives stated by the G20 and installment provisions of the Dodd-Frank Act and the European Market Infrastructure Regulation ("EMIR"), CME and important market participants across key jurisdictions agree that certain aspects of the proposed capital framework may require further refinement to properly reflect the risk management benefits of CCP clearing.

Provided below are targeted responses to certain inquiries and recommendations of the NPRs. With acknowledgement to footnote 42 of the Standardized Approach NPR, our comments reflect the expected inclusion of provisions stated in BCBS227 ("BCBS interim framework").

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major asset classes, including derivatives based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. The CME Group Exchanges serve the hedging, risk management, and trading needs of our global customer base by facilitating transactions through the CME Globex electronic trading platform, our open outcry trading facilities in New York and Chicago, and through privately negotiated transactions.

[2] CME Group response to BCBS206 (http://www.bis.org/publ/bcbs206/cme.pdf), BCBS190 (http://www.bis.org/publ/bcbs190/cmegroup.pdf) and BCBS164 (http://www.bis.org/publ/bcbs165/cmegroup.pdf)

I. Capitalization of Bank Exposures to Central Counterparties

Question 12 of the Standardized Approach NPR and Question 5 of Advanced Approaches and Market Risk NPR request comment on whether the proposal provides an appropriately risk sensitive treatment of (1) a transaction between a banking organization that is a clearing member and its client and (2) a clearing member's guarantee of its client's transaction with a CCP treating these exposures as OTC derivative contracts.

The Agencies also request comment on whether the adjustment of exposure amount would address possible disincentives for banking organizations that are clearing members[3] to facilitate the clearing of their clients' transactions. What other approaches should the Agencies consider?

Recommendation #1: To acknowledge certain practices and efficiencies afforded by central clearing, we support the recognition of shorter close-out periods for cleared transactions. We further encourage the Agencies to recognize varying close-out period conventions for specific cleared products that are commensurate with the risks, liquidity profiles, applicable close-out periods and further characteristics of these products as accredited within the CPSS-IOSCO Principles for Financial Market Infrastructures.

CME agrees that the final rules should incorporate shorter close-out periods for certain cleared and cleared-only derivative transactions relative to un-cleared bilateral transactions. To provide greater harmonization among various regulatory standards applicable to CCP clearing, we further recommend the Agencies utilize close-out period assumptions commensurate with the risks, liquidity and transparency, market composition and concentration characteristics of products that already exist in a cleared environment, relative to products recently introduced to centralized clearing. CME believes the BCBS interim framework's blanket assignment of a 5-day margin period of risk ("MPOR") for all cleared transactions lacks appropriate consideration for exchange traded derivatives and certain products that exemplify analogous features ("ETDs"), for instance, that exist in a central limit order book environment with substantial transaction volumes, with

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[3] The NPRs make multiple references to banking organizations as clearing members. To date, CME has not accepted U.S. insured depository institutions as clearing members due to certain issues arising from the Federal Deposit Insurance Corporation's receivership and conservatorship procedures. Specifically, we understand that all counterparties of a bank – including any CCP that has accepted the bank as a clearing member – are subject to a one-business day stay in insolvency. We recommend an exception to this stay for CCPs. This would be consistent with the exception for clearing organizations in the Orderly Liquidation Authority provisions of Dodd-Frank Act, which states:

> *. . . if the receiver fails to satisfy any such margin, collateral, or settlement obligations under the rules of the clearing organization, the clearing organization shall have the immediate right to exercise, and shall not be stayed from exercising, all of its rights and remedies under its rules and applicable law with respect to any qualified financial contract of the covered financial company, including, without limitation, the right to liquidate all positions and collateral of such covered financial company under the company's qualified financial contracts, and suspend or cease to act for such covered financial company, all in accordance with the rules of the clearing organization.*

§ 210(c)(8)(G). We also note that the Committee on Payment and Settlement Systems' ("CPSS") and Technical Committee of the International Organization of Securities Commissions' ("IOSCO") April 2012 *Principles for Financial Market Infrastructures* ("PFMIs") provide that a Financial Market Infrastructure ("FMI") (a term that includes CCPs) "should have a high degree of certainty that [actions taken under its default rules] will not be voided, reversed, *or subject to stays, including with respect to resolution regimes applicable to its participants.* Ambiguity about the enforceability of procedures could delay and possibly prevent an FMI from taking actions to fulfill its obligations to non-defaulting participants or to minimize its potential losses." See paragraph 3.1.9 (emphasis added).

I. Capitalization of Bank Exposures to Central Counterparties, cont.

commensurate historical price and liquidity characteristics that demonstrate a shorter close-out period is appropriate.

For instance, the evaluation of the market depth and product turnover draws further distinction between ETDs and over-the-counter ("OTC") derivatives. A TABB Group study[4] performed in 2010 indicated that ETDs turned over almost 10 times more frequently than OTC derivatives over the course of a year, with OTC derivative notional values turning over 2.7 times per year whereas ETDs notional values turned over 25 times per year. In addition to the higher notional turnover demonstrated by the ETD market, the study further notes transaction volumes of 3 billion in the ETD market versus 16 million in the OTC market.

Moreover, the clearing for ETDs is characterized as "positional" in nature as compared to the "transactional" nature of clearing for OTC derivatives. Positional-based clearing provides natural and automatic compression for long and short positions of the same contract that are novated into a single open position whereas transactional-based clearing maintains each open trade as an individual gross position. Although compression is available for some market participants in the OTC cleared environment, it remains a highly specialized and at times manual process that may challenge the efficiency for porting and liquidation. Therefore, the more compressed nature of ETDs provides greater efficiency, transparency and access to price and volume information in liquidation scenarios due to the breadth of the central limit order book. This further motivates and allows access to a broader group of market participants to partake in auctions whereby they can efficiently manage or liquidate the resulting exposure. As of 2010 the Tabb Group study estimates the number of market participants in the ETD market to be 5 million as compared to 30,000 in the OTC market.

Further, broad market participation within the ETD market further demonstrates efficient management of positions in both stressed and default scenarios. CME has encountered several scenarios in which large central limit order book product portfolios were liquidated in less than one day at a cost within margin requirement. For example, following the bankruptcy of Lehman Brothers Inc. in 2008, CME took control of Lehman's positions and conducted an auction that was completed the same day with a liquidation value well within the portfolios' $2.3 billion USD margin requirement.

CME maintains extensive historical price data that further demonstrates the adequacy of data in establishing margin levels and the appropriate exposure period to capture. For instance, we maintain price data for some of the most liquid exchange traded products dating back to 1982 for the first S&P 500 index contract, 1981 for Eurodollar futures, and 1977 for the first Treasury bond futures contract. With regard to daily volume, CME's Eurodollar, S&P and Treasury contracts combine for an average daily volume of approximately 7 million contracts in 2012, accounting for approximately 60% of CME's total average daily volume.[5]

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[4] A TABB Group Study: *The Global Risk Transfer Marker: Developments in OTC and Exchange-Traded Derivatives*, November 2010

[5] CME Group data October 19, 2012 YTD

I. Capitalization of Bank Exposures to Central Counterparties, cont.

With consideration to the above arguments, we recommend the Agencies provide greater consideration to the distinct characteristics of ETDs in establishing the appropriate MPOR and agree that for cleared swaps that aforementioned certain liquidity characteristics of ETDs a 5-day MPOR is appropriate.

In addition to demonstrable characteristics evidencing shorter close-out periods for ETDs, we call further attention to international guidance issued by CPSS-IOSCO and adopted by the Fed through Regulation HH with regard to designated FMU's adherence to the PFMIs. Consistent with key considerations detailed in Principle 6: Margin of the PFMIs, CME prescribes initial margin requirements that are, along with additional risk-based considerations, commensurate with the risk, liquidity, and close-out periods applicable to the variety of products and asset classes transacted on our exchanges. As described in Principle 6: Margin Requirements 3.6.3 "... OTC derivatives require more-conservative margin models because of their complexity and the greater uncertainty of the reliability of price quotes. Furthermore, the appropriate close-out period may vary among products and markets depending upon the product's liquidity, price and other characteristics."

Further consistent with Principle 6: Margin Close-out period 3.6.7,[7] in establishing initial margin requirements, CME provides extensive consideration to historical price and liquidity data that are further stressed and meticulously back-tested to ensure the appropriate exposure period is adopted. Proper appreciation for certain products that demonstrably adhere to the PFMIs and demonstrate a risk profile that does not require a 5-day MPOR would ensure that capital disincentives aren't introduced that undermine the efforts and sensible conclusions of other broad-based regulatory efforts (not least the Dodd-Frank Act and EMIR). As currently proposed, the capital framework appears inconsistent with various frameworks governing margin requirements for cleared exchanged-traded derivatives and therefore invites disproportionate capital requirements that are in conflict with clearing incentives.

The Agencies may attach confidence in the applied methodologies through a CCP's adherence to the PFMIs that, among other considerations, prescribe stringent confidence intervals, exposure coverage, back-testing analysis and independent model validations for margin models. CME notes that adherence to such principles, in addition to other PFMIs, is necessary to be considered a Qualified CCP, a designation we aspire to achieve.

[7] PFMI Principle 6: 3.6.7. Close-out period. A CCP should select an appropriate close-out period for each product that it clears and document the close-out periods and related analysis for each product type. A CCP should base its determination of the close-out periods for its initial margin model upon historical price and liquidity data, as well as reasonably foreseeable events in a default scenario. The close-out period should account for the impact of a participant's default on prevailing market conditions. Inferences about the potential impact of a default on the close-out period should be based on historical adverse events in the product cleared, such as significant reductions in trading or other market dislocations. The close-out period should be based on anticipated close-out times in stressed market conditions but may also take into account a CCP's ability to hedge effectively the defaulter's portfolio. Further, close-out periods should be set on a product-specific basis because less-liquid products might require significantly longer close-out periods. A CCP should also consider and address position concentrations, which can lengthen close-out timeframes and add to price volatility during close outs.

I. **Capitalization of Bank Exposures to Central Counterparties, cont.**

Question 13 of the Standardized Approach NPR and Question 6 of the Advanced Approaches and Market Risk NPR request comment on the proposed calculation of risk-based capital requirements for exposures to a QCCP. The Agencies question if there are specific types of exposures to certain QCCPs that would warrant an alternative risk-based capital approach.

Recommendation #2: To acknowledge the protections afforded to client accounts under regulations of the SEC and CFTC and to further distinguish additional client protections asserted by certain account structures, we request the Agencies confirm, through adoption, the stated eligibility criteria as provided for on page 52906 and 52988 of the Standardized Approach NPR and Advanced Approaches and Market Risk NPR, respectively.

Throughout the NPRs the Agencies draw distinction between typical CCP account structures where the clearing member acts as a financial intermediary ("principle model") and where the clearing member guarantees the performance of the client ("agency model"). As referenced in prior comment letters, greater credence should be afforded to QCCPs that employ an agency model whereby the clients' trades are effectively a trade between the client and the CCP, not least to appreciate the client protection scheme promulgated by the SEC and CFTC. In the event of a clearing member default, the structure of an agency relationship between the clearing member and its clients would facilitate various operational efficiencies including, but not limited to, the protection and portability of client positions and collateral. This agency relationship is fundamental to the operation of CME and is imbued throughout the rules of CME Group and the Commodity Exchange Act as well as the regulations of the CFTC.

CME supports the Agencies' statement within the preamble that the omnibus account structure in the United States would satisfy this requirement due to customer protections afforded under existing Securities and Exchange Commission ("SEC") and CFTC regulations including the CFTC's Part 190 Bankruptcy Rules (17 C.F.R. Part 190). To provide further clarity and provide assurance, we request the Agencies explicitly adopt the preamble's position in the final standards.

Recommendation #3: To recognize the distinction among the various components of trade exposure, we recommend the Agencies decouple the link between risk weights assigned to collateral trade exposure and those assigned to other components of trade exposure.

Under proposed sections _35(b)(3)(i) and _133(b)(3)(i), if collateral posted to a QCCP by a client is not protected from losses in a joint default scenario, the client's entire trade exposure—including collateral, current exposure, and potential future exposure—is ineligible for the 2 percent risk weight. CME believes that this result improperly conflates collateral-related exposure with other components of trade exposure. While protections against joint default may affect the safety of client collateral, such protections are demonstrably disconnected from the risk associated with current credit exposure and potential future exposures. Accordingly, CME recommends that the Agencies decouple the risk weight for client collateral from the risk weight for other components of a client's trade exposure.

II. Capitalization of Default Fund Contributions to Central Counterparties

Question 13 of the Standardized Approach NPR and Question 6 of the Advanced Approaches and Market Risk NPR request comment on the proposed calculation of risk-based capital requirements for exposures to a QCCP. The Agencies question if there are specific types of exposures to certain QCCPs that would warrant an alternative risk-based capital approach.

Recommendation #4: To recognize the robust and proven risk management models employed by Qualified CCPs, compliant with CPSS-IOSCO Principles for Financial Market Infrastructures and onward by prudential regulators, the Agencies should permit Qualified CCPs to apply approved Internal Models to quantify exposures related to CCP default fund contributions.

CME continues to champion the installation of a risk sensible approach to quantify capital requirements arising from clearing member default fund contributions. This position is supported by overwhelming industry feedback and by initial results of Quantitative Impact Studies administered by the BCBS. The current framework should be recalibrated to best appreciate the varying structures, practices, credit quality and financial resources afforded by a Qualified CCP. The primary components employed by CCPs to mitigate counterparty credit exposures, in addition to enterprise risk management practices, are funded initial margin, variation margin and clearing member default fund contributions; additionally, some CCPs contribute their own resources to the default waterfall, which should be taken into consideration as well (collectively, "aggregate CCP resources").

We were encouraged to hear the BCBS interim framework contemplated an alternative methodology; however we remain apprehensive that this method, method two, prudently considers aggregate CCP resources, a similar shortfall observed in superseded versions of method one, and might introduce incentives that are adverse to the intention of the capital standards. Similarly, we maintain that method one is risk insensitive and stands to create a variety of perverse incentives for clearing members to reduce both default fund contributions and margins or increase margins at the expense of reduced default fund contributions.

We further understand that the BCBS and CPSS-IOSCO have formed a working group to reconsider the interim methodologies and other certain aspects of the BCBS interim framework. CME supports exploring alternative solutions and would encourage the opportunity to discuss and jointly assess how each alternative translates into regulatory capital requirements to ensure a sensible and risk prudent measure is ultimately adopted. We encourage the Agencies to adopt a method that holistically considers the aggregate CCP resources (and corresponding conformance to the PFMIs) to ensure fair consideration is accorded to CCPs that employ varying methodologies when sizing margin and default fund requirements.

Consistent with the practices of the current bank capital framework, the Agencies should permit Qualified CCPs to utilize approved internal models. Further to QCCP adherence to the PFMIs, the use of internal models could be conditioned on observance to applicable CFTC and SEC (or other applicable) regulations and supervisory requirements governing risk modeling. To the extent the Agencies require review of any QCCP internal models, the Agencies could arrange an examination in coordination with Title VIII designated FMU review procedures. Acknowledging certain QCCPs may not maintain a level of expertise to qualify for internal models, the Agencies could prescribe a fallback to the prevailing interim methodologies.

III. **Additional Recommendation**

Recommendation #5: To better recognize acceptable collateral standards employed by certain Qualified CCPs, the Agencies should consider adjusting holding period assumptions under certain models to better align with the liquidity characteristics of such collateral.

The standard supervisory market price volatility haircuts described in the Standardized Approach NPR, as originally designed for the bilateral market, however, applicable to certain cleared transactions, prescribes a 10-day holding period assumption in computing the applicable haircut. We are concerned that these haircuts lack consideration to the profile and characteristics of collateral policies adopted by CCPs and that are further governed by prudential regulation. For example, the overwhelming majority of collateral on deposit at CME can be liquidated to cash on a same day basis under stressed market scenarios. CME routinely conducts liquidation drills with qualified, independent third parties to assess the liquidity profile of its collateral holdings. To complement our liquidity resources, CME maintains a committed, secured credit facility sized with consideration to assets that could challenge same day liquidation in a stressed market environment. The facility gives CME access to proceeds of a draw within 60 minutes of borrowing. Additionally, CME contracts with liquidation agents to facilitate prompt liquidation of collateral in a clearing member default. We therefore request the Agencies consider adjusting the holding period assumptions or allow CCPs to utilize alternative methods to compute appropriate haircuts for cleared transactions.

CME recognizes that the standard haircut schedule was designed to achieve a balance between simplicity and risk-sensitivity. However, for instance, the standard supervisory haircut table assigns mutual funds the most punitive haircut applicable to any security in which the funds invest. For money market funds ("MMFs"), that generally invest in short-term government securities, certificates of deposit, commercial paper, and other low-risk securities, the haircut table could assign a 25 percent haircut that appears to discount the enhanced standards and criteria relative to other mutual funds. In the U.S., it is accepted market practice to utilize MMFs to meet margin requirements; however, punitive haircut treatment could invite collateral inefficiencies to clearing. The distinctive features of MMFs, as governed and further enhanced in response to the 2008 credit crisis by SEC rule 2a-7,[8] provide a principled basis to distinguish MMFs from all other mutual funds.

We believe, the Agencies can effectuate this distinction without fundamentally altering the table. CME recommends that the Agencies bifurcate the "mutual funds" row of the standard supervisory haircut table into two rows, one labeled "money market funds" governed by SEC rule 2a-7 and the other labeled "other mutual funds." This treatment would parallel the current separation of equities into "main index equities" and "other publicly-traded equities." For MMFs, CME suggests a risk weight that reflects the cash-like characteristics of these instruments. As a starting point, the Agencies might consider the haircut assigned by the Federal Reserve Discount Window to the instruments that money market funds

[8] SEC Rule 2a-7 provides that MMFs may invest only in securities rated in one of the two highest short-term rating categories or, if unrated, of comparable quality to such securities; must invest at least 97 percent of their assets in securities rated in the highest short-term rating category or, if unrated, of comparable quality to such securities; must maintain a maximum weighted average maturity of 60 days and a maximum weighted average life of 120 days; and cannot invest more than 0.5 percent of their total assets in securities of a single issuer that is rated in the second-highest short-term rating category or, if unrated, of comparable quality to such securities.

invest in, namely Certificates of Deposit, Bankers' Acceptances, Commercial Paper, and Asset Backed Commercial Paper (currently 3 percent).[10]

IV. Conclusion

CME reiterates our support of the Agencies' efforts to provide greater incentives for central clearing, consistent with CPSS-IOSCO standards, and the need for careful evaluation of the motivations inspired by the proposed adjustments to the capital framework.

CME would like to thank the Agencies for the opportunity to provide these comments. We would be happy to further discuss and clarify any of the above issues with agency staff. If you have any comments or questions regarding this submission, please feel free to contact Tim Doar, Managing Director and Chief Risk Officer by telephone at (312) 930-3162 or by e-mail at Tim.Doar@cmegroup.com.

Sincerely,



Tim Doar
Managing Director and Chief Risk Officer, CME Clearing
Chicago Mercantile Exchange, Inc.
20 South Wacker Drive
Chicago, IL 60606

[10] CME also notes that the baseline 25 percent haircut proposed for corporate debt securities regardless of credit quality or maturity is unusually severe compared to the Agencies' existing rules and both existing and proposed international agreements. Under the Agencies' current Internal-Ratings-Based and Advanced Measurement Approaches rules, only *below-investment-grade* corporate debt receives a 25 percent haircut. Short-term corporate debt that is investment grade currently receives a haircut in the low-to-mid single digits. Likewise, under Basel II, Basel III, and the recently-published BCBS consultative document *Margin requirements for non-centrally-cleared derivatives* (July 2012), short-term, high quality corporate debt is assigned standard supervisory haircuts in the low-to-mid single digits.

November 27, 2012

Mark Carney
Chairman, Financial Stability Board (FSB)

Stefan Ingves
Chairman, Basel Committee on Banking Supervision (BCBS)

William Dudley
Chairman, Committee on the Global Financial System (CGFS)

Paul Tucker
Chairman, Committee on Payment and Settlement Systems (CPSS)

Masamichi Kono
Chairman, IOSCO Technical Committee

RE: BCBS 227 Interim Capital Framework

Dear Sirs:

The undersigned represent derivatives exchanges from jurisdictions across the world and a majority of the global exchange-traded derivatives (ETD) market. We support the G-20 objectives to strengthen the international financial system through regulatory reforms that will increase transparency in derivatives markets and reduce systemic risk. Although the well-established and highly regulated ETD markets did not contribute to the financial crisis, there are countless aspects of the current regulatory reform framework that will impact our markets and our customers. International standard setters and regional and national regulators must make every effort to avoid unintended consequences and ensure an appropriate level of regulatory consistency across jurisdictions. These objectives are critical to preserving the price discovery and risk management benefits that liquid and transparent ETD products provide for wholesale financial markets and the broader economy.

As described in detail below, we are concerned that provisions in BCBS 227 (Interim Capital Framework) that require capital to cover a 5-day margin period of risk (MPOR) for all cleared derivatives will significantly increase costs for ETDs and potentially make ETDs more expensive relative to cleared products that do not share the same liquidity, transparency and other risk-reducing characteristics. This result cuts directly against G-20 policy objectives to move opaque markets onto transparent trading venues. It is also inconsistent with the CPSS-IOSCO Principles for Financial Market Infrastructure (PFMI), regional and national regulatory frameworks, and clearing house risk-management practices which all appropriately recognize that that ETDs are less risky and therefore should be eligible for less burdensome margin treatment than other derivatives.

Unfortunately, the Interim Capital Framework is near final implementation in many jurisdictions. We urge the FSB and relevant international standard setting bodies to act quickly to eliminate the inappropriate one-size-fits-all approach by modifying the blanket 5-day requirement for all cleared instruments *before* regional and national capital requirements are finalized. The BCBS should

consult with the industry and other standard setters to develop an alternative approach consistent with the PFMI and based on criteria reflective of the risk profile of the derivative product. We are cognizant that inconsistent or conflicting provisions under banking, derivatives or other international standards have and will inevitably continue to arise due to the breadth and depth of the global reform effort. The FSB plays a critical role in monitoring the policy development work of the international standard setting bodies to ensure proper coordination. We commend the FSB for establishing its OTC Derivatives Working Group (ODWG) to look holistically at reforms to identify overlaps, gaps or conflicts in national frameworks that might compromise the achievement of the G-20 commitments.

We express our deep concern with the 5-day requirement within the broader context of other critical capital, margin, and market structure issues that are currently under deliberation by international standard setters. We urge the FSB and ODWG to ensure continued progress towards resolving other issues with BCBS standards that have the potential to undermine clearing of standardized products and access to client clearing. We also support international level efforts to appropriately calibrate market structure approaches across jurisdictions in order to avoid an un-level global playing field, market distortions, and regulatory arbitrage.

The Interim Capital Framework will Increase the Cost of ETDs and Could Potentially Make ETDs More Expensive than Less Liquid and Less Transparent Products

The Interim Capital Framework establishes capital requirements for banks' exposures to CCPs and to clients for whom they perform clearing services as direct clearing members of CCPs.[1] There are two related aspects of the BCBS standards that are going to significantly increase costs for ETDs, and could potentially make ETDs more expensive than less liquid and transparent products from a capital standpoint:

- First, the Interim Capital Framework will require clearing members to hold capital equivalent to a 5-day MPOR for all client "cleared derivative" positions.[2] Under the existing capital framework, products that demonstrate certain characteristics such as those exhibited by cleared ETDs are afforded capital treatment that matches the risk of the product. This would no longer be the case under the Interim Capital Framework.

- Second, under the bank capital framework, clearing members generally can reduce the 5-day capital requirement by applying the margin used to collateralize client positions. Under the PFMI and related national derivatives laws, cleared ETDs typically carry a 1-day or 2-day margin requirement versus the 5-day margin requirement assigned to cleared OTC products.[3] Applying the different margin requirements applicable to cleared products against the standard 5-day capital requirement could potentially result in higher costs for ETDs relative to products that do not share the same liquidity and transparency characteristics.

We understand the attraction of a simplistic capital rule that can be applied across jurisdictions without regard to the strength of the local clearing and regulatory regimes. However, applying this general and inflexible approach could unnecessarily drive trading to less transparent and less liquid venues, cutting against the goals to reduce systemic risk and increase transparency that are central to the G-20 mandates.

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[1] BCBS, *Capital Requirements for Bank Exposures to Central Counterparties*, July 2012 (BCBS 227).
[2] BCBS 227, Paragraph 113, Clearing Member Exposures to Clients.
[3] ESMA 2012/600 Draft technical standards under the Regulation (EU) no 648/2012 of the EP and of the EC on OTC Derivatives, CCP's and TR's, Art. 26 no 1 and 4; Commodity Exchange Act, Part 39, Section 39.13(g)(2)(ii)(a), 76 FR 69334 (11/8/2011).

Making ETDs More Expensive Cuts Directly Against the G-20 Objectives to Increase Price Transparency

The G-20 mandate called for all standardised OTC derivative contracts to be traded on exchanges or electronic trading platforms where appropriate, by the end of 2012 at the latest.[4] The FSB's recently published progress report on implementation of OTC derivatives market reforms recognizes the particular uncertainty that exists regarding future requirements for trading products subject to the clearing mandate on organized platforms.[5] For example, the Commodity Futures Trading Commission's (CFTC) Swap Execution Facility (SEF) rules are not yet finalized in the U.S., basic elements of Organized Trading Facilities (OTF) are still being debated at the EU legislative level under MiFID II/MiFIR, and a trading requirement has not been proposed in Asian jurisdictions.

In contrast, there has been significant progress across jurisdictions in implementing mandatory clearing of OTC derivatives. Although this progress furthers one critical G-20 goal to reduce systemic risk through central clearing, raising the cost of ETDs cuts directly against another key G-20 objective to increase price transparency. The BCBS standards should promote price transparency by incentivising the use of more liquid and transparent products rather than create economic disincentives to use ETDs.

CPSS-IOSCO and National Regulators have Recognised that Cleared Products with Certain Characteristics Warrant Shorter MPORs in Relation to Other Cleared Transactions

International frameworks and regional regulations recognize that products with different risk profiles warrant different levels of collateralization. In particular, these different risk profiles are clearly recognized within the PFMI. For example, Principle 6 states that, "A CCP should establish margin levels that are commensurate with the risks and unique attributes of each product, portfolio and market it serves."[6] The explanatory notes elaborate further, "...the appropriate close-out period may vary among products and markets depending upon the product's liquidity, price and other characteristics."[7]

This principle is reflected in regional and national derivatives laws and general CCP practice in setting margin: cleared ETDs typically carry a 1-day or 2-day MPOR versus the 5-day MPOR assigned to cleared bi-lateral trades. These distinctions are made on the basis that:

- ETDs have transparent pricing in deep, liquid markets which turn over almost 10 times more frequently than OTC derivatives.[8]

- ETDs are more standardized than other cleared products, providing greater efficiency, transparency and access to price and volume information in liquidation scenarios due to the concentration of interest in fewer distinct contracts.

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[4] G-20 Leaders' Statement, The Pittsburgh Summit, September 24 – 25, 2009, p. 9.
[5] FSB, *OTC Derivatives Market Reforms, Fourth Progress Report on Implementation*, 31 October 2012, p. 36. "Trading infrastructure is less developed than infrastructure for central clearing and trade reporting, owing to uncertainties about the scope and form of future regulatory frameworks for organized platform trading."
[6] PFMI, March 2011, Principle 6, p. 40.
[7] PFMI, March 2011, Principle 6, Explanatory Note 3.6.3, p. 41.
[8] TABB Group, *The New Global Risk Transfer Market: Transformation and the Status Quo*, August 2012.

- ETDs are efficiently liquidated and pose less risk than privately negotiated, highly customized, infrequently traded derivatives. Exchange trading and clearing of standardized products results in immediate netting of offsetting positions and thus permits swift, efficient liquidation of the portfolio.

We Urge the FSB to Resolve this Inconsistency at the International Level to Avoid the Potential for Conflicting Jurisdictional Approaches

We believe this issue requires immediate enhanced cooperation and action among the BCBS, CFGS, CPSS, and IOSCO due to the challenges faced in obtaining appropriate resolution at national levels. The BCBS Interim Capital Framework should be amended to modify the 5-day capital charge for clearing members using ETDs and replace it with a standard consistent with the PFMI and based on the risk profile, transparency and other characteristics of the product. As operators of global markets, we want to correct this disparity between international standards at the international level. Any alternative could result in inconsistent national outcomes and work against the G-20 objectives to promote adherence to international standards and further international harmonization.

* * *

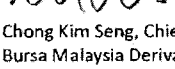
We greatly appreciate your consideration and are available to discuss this issue further at your convenience.



Edemir Pinto, Chief Executive Officer,
BM&F Bovespa



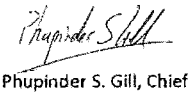
Fernando Centelles, Chief Executive Officer,
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Chong Kim Seng, Chief Executive Officer,
Bursa Malaysia Derivatives



Jorge Alegria, Chief Executive Officer,
MexDer



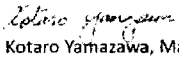
Phupinder S. Gill, Chief Executive Officer,
CME Group



Hans-Ole Jochumsen, Executive Vice President,
NasdaqOMX



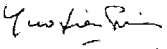
Christopher Fix, Chief Executive Officer,
Dubai Mercantile Exchange



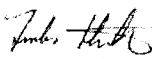
Kotaro Yamazawa, Managing Director,
Osaka Securities Exchange



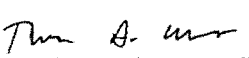
Andreas Preuss, Chief Executive Officer,
Eurex



Yeo Lian Sim, Chief Regulatory and Risk Officer,
SGX



Finbarr Hutcheson, Chief Executive Officer,
NYSE Liffe



Tom Kloet, Chief Executive Officer,
TMX Group

WORLD FEDERATION OF EXCHANGES

Paris, 27 November 2012

Mark Carney
Chairman, Financial Stability Board (FSB)

Stefan Ingves
Chairman, Basel Committee on Banking Supervision (BCBS)

William Dudley
Chairman, Committee on the Global Financial System (CGFS)

Paul Tucker
Chairman, Committee on Payment and Settlement Systems (CPSS)

Masamichi Kono
Chairman, IOSCO Technical Committee

RE: Advancing the G20 OTC Market Reforms by Correcting Inconsistencies in Derivative Margin Frameworks to Reflect Liquidity and Efficiency of Exchange Traded Derivative Markets

Dear Sirs:

The World Federation of Exchanges (WFE) is the global association representing the interests of 59 publicly regulated stock, futures, and options exchanges, as well as the central clearing houses that many of these exchanges operate. Collectively, WFE members represent the vast majority of the global exchange-traded equities and derivatives markets. The International Options Markets Association (IOMA) is the WFE's global association of options and futures exchange leaders. The member list of WFE is included in the annex to this letter.

During and immediately following the global financial crisis in 2008, the WFE vigorously advocated for reform and regulation of the OTC derivatives markets, which were identified as having made significant contributions to financial turmoil. WFE applauded the OTC reform commitments made by the G20 Finance Ministers at their November 2009 meeting in Pittsburgh. In support of the G20 commitments to increase transparency in derivative markets and to promote central clearing, our associations and members have continually engaged with global standard setters as well as national and regional policymaking bodies to implement regulatory reforms and address gaps and redundancies in national approaches and global frameworks.

With respect to risk management and margin standards, the WFE encourages the Financial Stability Board (FSB) to ensure that inconsistencies in the international guidelines in relation to exchange traded derivative (ETD) margin standards and banking regulatory capital standards do not undermine the G20 commitments of moving standardized derivatives to central clearing and, when appropriate, to highly transparent trading platforms such as the regulated exchanges operated by WFE members.

Specifically, we ask that the FSB coordinate and collaborate with the Basel Committee on Banking Supervision (BCBS), the Committee on the Global Financial System (CGFS), the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissioners (IOSCO) to resolve differences between the initial margin approach set out in the CPSS-IOSCO Principles for Financial Market Infrastructure (PFMIs) (and reflected in some national regulatory rules or proposals for ETDs) and the conflicting Basel Committee on Banking Supervision (BCBS) Interim Capital Framework.

The Interim Capital Framework referred to above seeks to apply a blanket 5-day margin period of risk standard to highly liquid and transparent ETDs. The CPSS-IOSCO PFMIs appropriately distinguish between the risk profiles of ETDs and cleared OTC products.[1] CPSS-IOSCO PFMI's are reflected in regional and national margin and risk management regulatory frameworks around the world. These margin frameworks recognize the deep liquidity, transparent pricing, significant turnover rates, and overall efficiency of most ETDs relative to OTC derivatives and, in some cases, apply a 1 to 2-day margin period at risk standard for ETDs.[2]

The significant liquidity and turnover advantages of ETD markets are confirmed by a recent study commissioned by the WFE and completed by the TABB Group which estimates that there are approximately 9,800 OTC trades per day across all OTC asset classes contrasted with nearly 6.2 million trades per day in global interest rate futures market alone. This equates to a 630 times greater turnover rate for exchange traded interest rate contracts compared to the turnover rate of all of the asset classes that make up the OTC derivatives market.[3] Due to their significant liquidity and turnover advantages as well as the extensive

[1] *CPSS-IOSCO Principles for Financial Market Infrastructure*. "When setting margin requirements, a CCP should have a margin system that establishes margin levels commensurate with the risks and particular attributes of each product, portfolio, and market it serves. Product risk characteristics can include, but are not limited to, price volatility and correlation, non-linear price characteristics, jump-to-default risk, market liquidity, possible liquidation procedures (for example, tender by or commission to market-makers), and correlation between price and position such as wrong-way risk. Margin requirements need to account for the complexity of the underlying instruments and the availability of timely, high-quality pricing data. For example, OTC derivatives require more-conservative margin models because of their complexity and the greater uncertainty of the reliability of price quotes" (Explanatory Note 3.6.3). "A CCP should adopt initial margin models and parameters that are risk-based and generate margin requirements that are sufficient to cover its potential future exposures to participants in the interval between the last margin collection and the close out of positions following a participant default. Initial margin should meet an established single-tailed confidence level of at least 99 percent with respect to the estimated distribution of future exposure." (V. Appendix 3.6.6).

[2] ESMA 2012/600 Draft technical standards under the Regulation (EU) no 648/2012 of the EP and of the EC on OTC Derivatives, CCP's and TR's / Art. 26 no 1 and 4 Title: 17 CFR Parts 1, 21, 39 and 140 Derivatives Clearing Organization General Provisions and Core Principles. U.S. Federal Register Citation: 76 FR 69334 (11/8/2011).

[3] TABB estimates that there are 4300 trade per minute in the global interest rate futures markets which equals an average of 6,192,000 trades in a 24 hour period. TABB estimates that 6.8 trades per minute occur in the

availability of pricing data, ETDs are usually efficiently liquidated and generally pose less risk than privately negotiated, customized, and less frequently traded OTC derivatives.

If adopted by the BCBS and implemented by national bank regulators, the static 5-day margin period of risk standard will not only be in conflict with the CPSS-IOSCO PFMIs but also have the effect of increasing costs for client users of ETDs.[4] This may force exchange users (e.g. manufacturers, food producers, employee pension funds, and investors) to either discontinue critical hedging practices or move activity to the less transparent OTC derivative markets. Such outcomes would clearly undermine the G20 OTC market reform commitments.

The WFE respectfully requests global standard setters to eliminate the 5-day margin period of risk banking capital standard for exchange traded derivatives and demonstrate international support for the more appropriate 1 to 2-day standard for the highly liquid, transparent, and efficient exchange traded derivative markets. This standard should apply across all methods permitted under the Basel framework to compute counterparty credit risk exposure for ETDs. Such action by global standard setters will be instrumental in advancing the G20's commitment to bring increased transparency and the safety and soundness of central clearing to the global derivatives market and broader financial system.

As the global associations for exchanges and clearing houses, the WFE and IOMA appreciate your consideration and stand ready to lend our members' collective expertise to this critical discussion.

Cordially yours,

Huseyin Erkan
Chief Executive Officer
Word Federation of Exchanges

Jorge Alegria Formoso
Chairman, IOMA, and
Chief Executive Officer, MexDer

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entire OTC market which equals 9,792 trades in a 24 hour period. See pages 40-41: *The New Global Risk Transfer Market: Transformation and the Status Quo*, TABB Group, August 2012.

[4]The Interim Capital Framework establishes capital requirements for banks' exposures to CCPs and to clients for whom they perform clearing services as direct clearing members of CCPs. There are two drivers that will result in higher capital requirements for ETDs, or prompt a significant increase in collateralisation requirements established by banks offering clearing services: 1)The Interim Capital Framework will require clearing members to hold capital equivalent to a 5-day margin period of risk (MPOR) for all client "cleared derivative" positions. Under the prior capital framework, products that demonstrated certain characteristics such as those exhibited by cleared ETDs were afforded capital treatment that matched the risk of the product; and 2) The Interim Capital Framework allows clearing members to offset this 5-day capital requirement with the margin held against the client positions.[4] Under the PFMIs and related national derivatives laws, cleared ETDs typically carry a 1-day or 2-day margin requirement versus the 5-day margin requirement assigned to cleared OTC products.[4] This offset results in a 4-day or 3-day capital charge for ETDs versus 0-day charge for cleared OTC. *BCBS, Capital Requirements for Bank Exposures to Central Counterparties, July 2012 (BCBS 227)*

STATEMENT OF

GEORGE FRENCH
DEPUTY DIRECTOR, POLICY
DIVISION OF RISK MANAGEMENT SUPERVISION
FEDERAL DEPOSIT INSURANCE CORPORATION

on

EXAMINING THE IMPACT OF THE PRPOSED RULES TO IMPLEMENT BASEL III CAPITAL STANDARDS

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONUMER CREDIT
AND
SUBCOMMITTEE ON INSURANCE, HOUSING AND COMMUNITY OPPORTUNITY
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

November 29, 2012
2128 Rayburn House Office Building

Chairman Capito, Chairman Biggert, Ranking Member Maloney, Ranking Member Gutierrez and members of the Subcommittees, thank you for the opportunity to testify today on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the recently proposed changes to the federal banking agencies' regulatory capital requirements. The FDIC has had a longstanding concern for stronger bank capital requirements, and we welcome the opportunity to discuss these important proposals. The federal banking agencies have received and are carefully reviewing a significant number of comments on these proposals.

Background

As you know, in June of this year, the federal banking agencies issued for public comment three separate Notices of Proposed Rulemaking, or NPRs, proposing changes to the regulatory capital requirements. Two of the NPRs would implement the recent Basel III standards developed by the Basel Committee on Banking Supervision and update our regulations in conformity with Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The first of these, the Basel III NPR, would strengthen the quality of bank capital and increase its required level for all institutions, including community banks. The Basel III NPR also includes selected Basel III capital requirements applicable only to banking organizations that use the agencies' Advanced Approaches capital regulation. The second NPR, the Advanced Approaches NPR, proposes additional requirements from the Basel III agreement and other Basel standards for these large Advanced Approaches organizations. The third NPR, referred to as the

Standardized Approach NPR, proposes changes to the risk-weighting of assets and replaces credit ratings in the agencies' capital regulations in accordance with Section 939A of the Dodd-Frank Act. This NPR would apply to all institutions. The comment period on all three NPRs closed on October 22, 2012. Also, in June of this year, the agencies finalized regulations that change the way banks with a large volume of trading activity calculate capital requirements for market risk.

The agencies proposed the NPRs to address deficiencies in bank capital requirements that became evident in the recent banking crisis. A number of banking organizations failed or required federal assistance during the crisis, and the U.S. government provided capital, liquidity and guarantees to a significant portion of the financial sector, including depository institution holding companies and their affiliates. Since January 1, 2008, 463 FDIC-insured banks have failed.

In light of this experience, strengthening bank capital requirements seems to be an appropriate and important step. All banks need strong capital to navigate periods of economic turbulence while continuing to serve their important role as financial intermediaries to the economy. The changes proposed in the NPRs are intended to address identified deficiencies in the existing capital regime and provide greater comfort in the capital adequacy of our banking system. At the same time, reviewing the numerous comments received will help us address concerns about the costs and potential unintended consequences of various aspects of the proposals.

My testimony will describe the proposed rules in more detail, along with some of the most frequently identified concerns among the more than 2000 comments we have received. It is worth emphasizing that the rulemaking process is ongoing and the agencies have not yet reached final decisions regarding how to address the various issues that have been raised with respect to the NPRs.

The Basel III NPR

One of the critical lessons learned from the recent financial crisis was that high-quality, loss-absorbing capital is essential to ensuring the safety and soundness of financial institutions. As such, in the aftermath of the crisis, the FDIC and the other U.S. banking agencies participated in an intensive international effort to strengthen bank capital standards. The result of these efforts is the Basel III capital agreement. In broad terms, the Basel III capital standards aim to improve the quality and increase the required level of bank capital. Collectively, Basel III and other standards published by the Basel Committee address a number of features of capital regulation that allowed for an excessive use of leverage in the years leading up to the crisis.

The FDIC Board of Directors voted to issue the Basel III NPR for public comment on June 12, 2012. The Basel III NPR proposes to strengthen the definition of regulatory capital to better absorb losses than under current rules, and to increase the required level of capital. These changes are proposed to be phased in over time. The NPR also includes selected requirements that apply only to banks using the agencies' Advanced Approaches capital regulation.

The Basel III NPR proposes a number of changes to strengthen the definition of capital. The most important of these changes are described below.

- Under current rules, common equity is permitted to comprise as little as half of Tier 1 capital, reducing the loss absorbency of, and market confidence in, the regulatory capital measure. The Basel III NPR proposes a new risk-based capital requirement for "common equity Tier 1," a form of regulatory capital that would be more reliably available to absorb losses.
- Intangible assets, except for a limited amount of mortgage servicing rights, are deducted from capital in the Basel III NPR. Intangible assets, which are generally difficult to sell in order to absorb losses, are subject to limits in current capital rules, but the NPR makes these limits more stringent.
- Deferred tax assets are subject to stricter limits in the Basel III NPR. These assets, as analysts noted during the crisis, may have little value when a bank is losing money and capital support is most needed.
- Investments in the capital instruments of other financial institutions that exceed specified thresholds are deducted from capital in the Basel III NPR. It was evident in the recent crisis that inclusion of large amounts of such investments in a banking organization's capital can create a chain of interconnected losses that exacerbates a banking crisis.

- Minority interests in consolidated subsidiaries are subject to stricter limits in the Basel III NPR. Minority interests can absorb losses in a specific subsidiary but may be unavailable to absorb losses throughout an organization.
- Trust Preferred Securities (TruPS) are subject to a phase-out from Bank Holding Companies' (BHCs) Tier 1 capital in the Basel III NPR (a three year phase-out for large BHCs and a ten-year phase-out for smaller BHCs). TruPS can absorb losses in a failure, but do not absorb losses on a going-concern basis. The application of this proposed change to smaller BHCs, and the change to the treatment of accumulated other comprehensive income described below, have been frequent subjects of concern from commenters.
- Accumulated other comprehensive income (AOCI), which includes unrealized gains and losses on available-for-sale (AFS) securities, is proposed to be included in the calculation of capital under the Basel III NPR.[1] Incorporating these gains and losses as proposed in the NPR may result in a better indicator of the bank's capital strength if it is forced to sell these securities in an adverse economic environment.

We are carefully considering the comments we have received on each of these proposed changes to the definition of capital.

[1] Under existing regulations, unrealized gains and losses on AFS debt securities are not included in regulatory Tier 1 capital. Unrealized losses on AFS equity securities with readily determinable fair value are included in Tier 1 capital, while a portion of unrealized gains on AFS equity securities can be included in Tier 2 capital.

As noted above, the Basel III NPR proposes to establish a new risk-based capital requirement for "common equity Tier 1" capital. Under the NPR, banks would need to hold common equity Tier 1 capital in an amount that is at least 4.5 percent of risk-weighted assets in order to be considered "Adequately Capitalized." The NPR also proposes to increase by two percentage points the minimum and "Well Capitalized" levels for the Tier 1 risk-based capital ratios that are part of the agencies' Prompt Corrective Action (PCA) regulations.

The Basel III NPR also proposes a capital buffer incorporating a sliding scale of dividend restrictions for banks whose risk-based capital ratios are less than 2.5 percentage points higher than the regulatory minimums. The purpose of the buffer is to encourage banks to maintain a cushion of capital above the regulatory minimums so they will be able to continue to lend during periods of economic adversity without breaching those minimums. The Basel III buffer is similar to the statutory requirement that the agencies' PCA regulations include a capital ratio threshold for banks to be considered "Well Capitalized."

In addition, the Basel III NPR requires banks that use the Advanced Approaches capital regulation to comply with a supplementary leverage ratio that includes certain off-balance sheet items in the denominator. The FDIC views the leverage ratio as a foundational measure of capital, and we are highly supportive of its inclusion in the Basel framework. The complexities specific to the Basel III leverage ratio, however, are mainly relevant for very large institutions with extensive off-balance sheet activities. For

that reason, the agencies have proposed that the Basel III leverage ratio would be a supplementary requirement, and only applied to banks using the Advanced Approaches capital regulation. The existing U.S. leverage ratio requirements would remain in effect for all U.S. banks.

The Basel III NPR also requires Advanced Approach banking organizations to hold additional capital in the form of a "countercyclical buffer" if the agencies determine that the banking industry is experiencing excessive credit growth. The NPR indicated that the countercyclical buffer initially would be set at zero, with the agencies acting jointly to raise that level, if and when credit conditions warranted putting this buffer into effect. If a determination was made that the buffer was necessary, the amount of the buffer could be as much as 2.5 percent of risk weighted assets. The countercyclical buffer would serve to provide additional capital for the losses that often follow a period of excessive credit growth, and may itself serve as a check on excessive growth. Again, the NPR indicates that the countercyclical buffer would only be in effect when credit conditions warrant and would be zero at other times.

The minimum capital ratios and capital buffers proposed in the Basel III NPR were developed as part of a Basel Committee effort, in which the agencies participated, to estimate the amount of bank capital needed to absorb losses in severe economic scenarios including the losses experienced in banking crises in different countries over time. The results of this analysis were published in October, 2010.[2] The results suggest that bank

[2] "Calibrating Regulatory Minimum Capital Requirements and Capital Buffers: A Top-down Approach," October, 2010, Basel Committee on Bank Supervision; http://www.bis.org/publ/bcbs180.htm.

capital ratios at the levels agreed to by the Basel Committee and proposed in the Basel III NPR would provide reasonable assurance that banks would be able to absorb losses during a period of economic adversity while continuing to be able to lend -- and certainly greater assurance than exists under the current rules.

While working as part of the Basel Committee to develop the capital ratios that were proposed in the Basel III NPR, the agencies were mindful that while the requirements should be sufficient to enable banks to withstand a period of economic adversity, they should not be so high as to choke off prudent lending or normal economic activity. The agencies participated in international efforts to evaluate the potential effect of the higher bank capital requirements on economic activity. This work focused on two issues. One issue is the potential costs to the broader economy of an insufficiently capitalized banking system. Experience suggests that banking crises have consistently been followed by large and long-lasting reductions in economic activity. The other -- and competing issue -- is the costs that higher capital requirements might impose by increasing the cost of credit and reducing the volume of lending.

The literature reviews and other analysis conducted as part of these international efforts generally concluded that within the range of capital requirements being considered, the economic benefits of higher capital requirements from reducing the frequency and severity of banking crises would exceed the economic costs resulting from a modest increase in the cost of credit.[3] This analysis supports the overall conclusion that

[3] "An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements," August, 2010; Basel Committee on Bank Supervision; http://www.bis.org/publ/bcbs173.htm, and

an increase in bank capital requirements from current levels is warranted. Pre-crisis increases in leverage permitted by the current capital rules did stimulate financial institution growth and earnings for a time, but the real economy ultimately suffered a significant cost when the financial cycle turned. In addition to the financial institution failures and government assistance mentioned earlier in this testimony, the U.S. economy experienced a loss of over eight and a half million payroll jobs as a result of the recession, and it suffered a 35 percent decline in home prices as well as over 10 million new foreclosures. The decline in employment and economic activity reduced revenues at all levels of government, with fiscal effects that reverberate back to the real economy.

While we view strengthening bank capital requirements as an appropriate goal to reduce the likelihood and severity of future banking crises, the agencies also are mindful that the proposals in these three NPRs represent significant change. The review of comments that is now underway is expected to shed considerable light on the potential for unintended consequences associated with specific aspects of these proposals.

Advanced Approaches NPR

In addition to the Basel III NPR, the FDIC Board of Directors approved a separate NPR on June 12 that proposes a number of enhancements to the calculation of risk-weighted assets for the large, complex banks using the Advanced Approaches. This NPR proposes to implement aspects of Basel III that are designed to improve and strengthen modeling standards, the treatment of counterparty credit risk, credit risks associated with

"Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements (MAG Analysis)," December, 2010, Financial Stability Board and Basel Committee on Bank Supervision; http://www.bis.org/publ/othp12.pdf.

securitization exposures, and disclosure requirements. The proposal also contains alternatives to credit ratings consistent with Section 939A of the Dodd-Frank Act. The proposals in this NPR would strengthen the existing Advanced Approaches capital rules, particularly those related to capital requirements for derivatives.

The FDIC has had a longstanding concern about the reliance in the Advanced Approaches rule on a bank's own models and risk estimates. Section 171 of the Dodd-Frank Act (the Collins Amendment) addresses this concern by placing a floor under the Advanced Approaches capital requirements that ensures that the Advanced Approaches capital requirements are not less than the requirements that are generally applicable to other banks.

Standardized Approach NPR

The third NPR, the Standardized Approach proposal, includes a number of proposed changes to the calculation of risk-weighted assets in the agencies' general risk-based capital rules. The proposal also includes alternatives to credit ratings consistent with Section 939A of the Dodd-Frank Act. The capital requirements proposed in the Standardized Approach NPR are separate and distinct from those under the Basel III framework.

The Standardized Approach proposal was designed to address shortcomings in the measurement of risk-weighted assets that became apparent during the recent financial crisis. In part, this is addressed by implementing certain changes based on the Basel II

Standardized Approach contained in the Basel international regulatory capital standards and by replacing credit ratings consistent with section 939A of the Dodd-Frank Act. The proposed risk-weightings and segmentation methodologies for residential mortgages were developed by the federal banking agencies in response to issues observed during the financial crisis. Among other things, the proposed rule would:

- revise risk weights for residential mortgages based on loan-to-value ratios and certain product and underwriting features;
- increase capital requirements for past-due loans, high volatility commercial real estate exposures, and certain short-term loan commitments;
- expand the recognition of collateral and guarantors in determining risk-weighted assets;
- remove references to credit ratings; and
- establish due-diligence requirements for securitization exposures.

FDIC-insured institutions have strengthened their capital ratios since 2008. We have estimated that the large majority of insured banks would meet the capital requirements resulting from the combined implementation of the Basel III NPR and the Standardized Approach NPR. The attachment to this testimony describes the methodology for these estimates and the results for banks in different size groups. These estimates suggest that for most insured banks, the proposals would not result in a need to raise new capital. It should be emphasized that these are estimates, and that institutions themselves will have better information about the specific factors used in the proposed

capital calculations than the agencies currently collect in financial reports. In particular, our estimates did not attempt to address the extent to which institutions might feel the need to hold additional capital buffers beyond those specifically proposed, for example, to offset future changes in AOCI. Our review of the public comments is expected to shed additional light on such issues.

Final Market Risk Rule

On June 12, the FDIC Board of Directors also approved the final regulation making improvements to the Market Risk Rule. This final regulation, which takes effect on January 1, 2013, addresses important weaknesses of the current Market Risk Rule to reflect lessons learned in the financial crisis. Leading up to the crisis, low capital requirements under the current Market Risk Rule encouraged institutions to place illiquid, high-risk assets in their trading books. Large mark-to-market losses on these assets played an important role in fueling the financial crisis during its early stages. The final regulation requires an appropriate increase in the stringency of the Market Risk Rule that will better address such risks.

This final rule applies only to the largest institutions that have significant trading activities. It is based on reforms that were agreed to internationally with the Basel Committee's 2009 revisions to the Basel II market risk framework. These revisions are part of what is generally referred to as the Basel II.5 reforms.

Concerns have been expressed that the Market Risk Rule, while improved, is still too reliant on internal models. The idea of establishing a simple, non-modeled and higher minimum capital floor for all trading book capital requirements is worthy of further study, and is in fact being considered as part of a fundamental review of trading book capital requirements being conducted by the Basel Committee.

Outreach and Comments

As the primary federal supervisor for the majority of community banks, the FDIC is particularly focused on ensuring that community banks are able to properly analyze the capital proposals and assess their impact. Since the Basel III NPR and the Standardized Approach NPR would affect all banks, the FDIC undertook an outreach agenda to assist community banks in analyzing the impact of the proposals.

First, both the Basel III NPR and the Standardized Approach NPR contain a relatively short and concise addendum designed to aid smaller banks in identifying and understanding the aspects of the proposal that would apply to them.

Second, FDIC staff hosted six community bank capital outreach sessions, one in each of the FDIC regional offices. Each session included an FDIC staff overview of the NPRs that identified the most significant changes for community banking organizations, and a question-and-answer session for the bankers in attendance.

Third, the FDIC posted an on-demand video on its Website that contains the same information provided by the FDIC in the live outreach sessions. Copies of the materials provided to bankers at the live outreach sessions are also posted online.

Fourth, FDIC staff hosted a national call to address the questions most frequently asked by attendees at the live outreach program sessions.

Finally, the FDIC, along with the other banking agencies, developed a Regulatory Capital Estimation Tool designed to assist community banking organizations and other interested parties in evaluating the potential effect that the Basel III NPR and the Standardized Approach NPR could have on their capital ratios.

We believe that these outreach efforts have helped many bankers understand these proposals and identify the issues that are of concern to them. As of November 16, the FDIC had received more than 2000 comments. The vast majority of these comments are from community banks. Their comments have been highly substantive and provide significant information regarding the possible impact of the proposals.

The FDIC is in the process of reviewing all of the comments received. To date, many commenters have raised concerns about the generally higher level of capital requirements for community banks. A number of commenters have requested that the agencies not apply the Basel III or Standardized Approach NPRs to community banks.

Some commenters have requested that the agencies withdraw the Standardized Approach NPR.

In addition to these general comments, a few more specific topics have been mentioned quite frequently. First, many commenters have expressed concern that the Basel III NPR proposes to include AOCI in the calculation of regulatory capital, thereby including gains and losses on available-for-sale debt securities. These commenters believe that the inclusion of AOCI will increase the volatility of regulatory capital, forcing banks to hold additional capital buffers, and complicate their ability to manage interest rate risk and comply with legal lending limits. Also with respect to the Basel III NPR, many commenters have expressed concern that trust preferred securities issued before May 19, 2010, by community bank holding companies with less than $15 billion in assets are proposed to be phased out of Tier 1 capital.

With respect to the Standardized Approach NPR, many commenters have expressed concern about the increased complexity and systems costs of the proposed new methods for asset risk weighting, as well as the proposed increase in risk weight for certain exposures, particularly past due exposures and residential mortgages. Many community bank commenters have indicated that the proposed risk-weightings for residential mortgages will force them to curtail or exit residential mortgage lending because of what they view as the excessively high level of some of these risk weights. Commenters also express concern about how the new risk weights might interact with a number of pending mortgage regulations whose final form remains uncertain.

Conclusion

In conclusion, along with our fellow regulators, the FDIC is carefully reviewing the comments we have received regarding the NPRs. These are proposed rules, and we expect to make changes based on the comments. The basic purpose of the Basel III framework is to strengthen the long-term quality and quantity of the capital base of the U.S. banking system. In light of the recent financial crisis, that would appear to be an appropriate and important goal. However, that goal should be achieved in a way that is responsive to the concerns expressed by community banks about the potential for unintended consequences.

Bank Impact Analysis
Impact of: Basel 3 with Standardized approach

in thousands	Current Data			Estimated Basel III Capital		
Bank Size	Count of Banks	Tier 1 Capital ($000)	Total Risk-Based Capital ($000)	Common Equity Tier 1 Capital	Tier 1 Capital ($000)	Total Risk-Based Capital ($000)
greater than $250B	6	$ 493,639,368	$ 615,172,789	$ 483,801,991	$ 484,301,991	$ 606,925,348
$100B - 250B	13	$ 182,216,148	$ 211,616,800	$ 175,318,671	$ 175,318,746	$ 204,621,117
$10 - 100B	89	$ 269,843,538	$ 305,163,612	$ 262,137,865	$ 264,856,372	$ 300,202,812
$1 - 10B	555	$ 145,674,132	$ 157,527,571	$ 143,362,961	$ 144,923,461	$ 156,700,358
$250m to $1B	1,900	$ 88,907,975	$ 96,142,159	$ 89,506,338	$ 90,226,284	$ 97,385,922
less than $250m	4,767	$ 55,600,188	$ 59,404,342	$ 56,526,743	$ 56,960,126	$ 60,768,936
Grand Total	7,330	$ 1,235,881,349	$ 1,445,027,273	$ 1,210,654,569	$ 1,216,586,980	$ 1,426,604,493

Additional capital required to meet alternative capital standards:

in thousands	Minimum required (adequately capitalized)			Well Capitalized			Minimum required plus CCB		
Bank Size	Common Equity T1 RBC (4.5%)	Tier 1 RBC (6.0%)	Total RBC ratio (8.0%)	Common Equity T1 RBC (6.5%)	Tier 1 RBC (8.0%)	Total RBC ratio (10.0%)	Common Equity Tier 1 RBC (7.0%)	Tier 1 RBC (8.5%)	Total RBC ratio (10.5%)
greater than $250B	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ 43,426	$ -
$100B - 250B	$ -	$ -	$ -	$ -	$ 257,639	$ -	$ -	$ 766,128	$ -
$10 - 100B	$ 2,407	$ 76,240	$ 230,110	$ 314,104	$ 1,162,912	$ 906,847	$ 412,536	$ 2,009,691	$ 1,727,627
$1 - 10B	$ 25,296	$ 28,301	$ 64,113	$ 56,659	$ 166,648	$ 417,516	$ 73,909	$ 304,808	$ 796,817
$250m to $1B	$ 90,087	$ 38,575	$ 48,874	$ 154,998	$ 113,225	$ 236,187	$ 179,015	$ 183,454	$ 406,942
less than $250m	$ 42,629	$ 37,550	$ 40,868	$ 54,898	$ 50,490	$ 90,776	$ 62,058	$ 63,821	$ 148,719
Grand Total	$ 160,419	$ 180,667	$ 383,965	$ 580,659	$ 1,750,915	$ 1,651,326	$ 727,518	$ 3,373,330	$ 3,080,105

Count of banks that fail to meet following capital standards:*

	Minimum required (adequately capitalized):			Well Capitalized			Minimum required plus CCB		
Bank Size	CET1 RBC (4.5%)	Tier 1 RBC (6.0%)	Total RBC ratio (8.0%)	CET1 RBC (6.5%)	Tier 1 RBC (8.0%)	Total RBC ratio (10.0%)	CET1 RBC (7%)	Tier 1 RBC (8.5%)	Total RBC ratio (10.5%)
greater than $250B	-	-	-	-	-	-	-	1	-
$100B - 250B	-	-	-	-	1	-	-	1	-
$10 - 100B	1	1	2	2	5	5	2	7	12
$1 - 10B	2	2	3	2	9	25	3	16	42
$250m to $1B	7	5	7	12	23	62	17	41	107
less than $250m	7	5	6	14	21	83	21	45	159
Grand Total	17	13	18	30	59	175	43	111	320

Source: Call report data (3.31.12) and FDIC estimates
*** Count of banks that fail to meet the Basel III and Standardized Approach capital standards do not include approximately 233 banks that do not meet the current RBC standards.**

Abbrevaitions:
RBC = Risk Based Capital
CCB = Capital conservation buffer
CET1 = Common Equity Tier 1
B = billions
M = millions

FDIC Methodology for Estimating the Impact of the Basel III and Standardized Approach NPRs on US Banks

FDIC staff analyzed the impact of the proposed changes contained in the Basel III and Standardized Approach NPRs using Call Report data and the assumptions provided below.

Basel III (Numerator of risk-based capital ratios)
The chart below summarizes the approach and assumptions used to estimate common equity tier 1, tier 1 and total capital.

	Capital component	Call Report Line	Call Report Field	Notes and assumptions
+	Common Stock	RC-24	RCFD3230	
+	Surplus	RC-25	RCFD3839	
+	Retained Earnings	RC-26 a.	RCFD3632	
+	AOCI	RC-26 b.	RCFDB530	
+	Other Equity Capital Components	RC-26 c.	RCFDA130	
-	Goodwill & Other Intangible Assets	RC-R-7 a.	RCFDB590	
-	Change in FV of Financial Liabilities	RC-R-7 b.	RCFDF264	Deduct gains; add back losses
-	PCCR and Non-Mortgage Servicing Assets	RC-M-2 b.	RCFDB026	
-	Net deferred tax assets	RC-F-2	RCFD2148	Calculation / Assumed 40% deducted as 'carry forward' DTAs
+	Minority Interest	RC-R-6	RCFDB589	Calculation / Assumed 40% included in CET1 capital
Deductions for components exceeding 10%/15% threshold limitations				
-	Deferred Tax Assets not previously deducted	RC-F-2	RCFD2148	Calculation / Assumed 60% of DTAs related to temporary differences
-	Investments in financial institutions	RC-8	RCFD2130	Calculation / Assumed 40% of investments in FIs would be in the form of common stock
-	Mortgage servicing assets	RC-M-2.a(1)	RCFDA590	
Common Equity Tier 1 Capital				
+	Perpetual Preferred Stock & Surplus	RC-23	RCFD3838	
-	Non-Qualifying Perpetual Preferred	RC-R-5	RCFDB588	
-	investments in unconsolidated financial institutions over threshold limits	RC-B 6.a. Col. B RC-B M6.a. Col. D RC-D 3.a.	RCFDG849 RCFDG851 RCFDG299	
+	Qualifying minority interests in consolidated subs	RC-R-6	RCFDB589	Calculation / Assumed 60% included in Tier 1 capital
Tier 1 Capital				
+	Qualifying subordinated debt and redeemable preferred stock	RC-R 12	RCFD5306	
+	Non-Qualifying Perpetual Preferred	RC-R-5	RCFDB588	
+	Allowance for loan and lease losses includible in Tier 2 capital	RC-R 14	RCFD5310	
+	Other Tier 2 capital components	RC-R 16	RCFDB594	
Total Capital				

Standardized Approach (Denominator of risk-based capital ratios)
To estimate the effects of the Standardized Approach, FDIC staff started with each bank's current risk-weighted assets (RWA), as reported on the Call Report, and adjusted RWAs for asset categories where risk weights would change under the proposed rule. The chart below shows the asset categories and assumed change in risk-weights proposed under the Standardized Approach. Following the chart is a description the assumptions used in the analysis.

Asset category	Current: Appendix A RW	Projected: Standardized RW
1-4 Family Residential Loans	50%	75%
High Volatility Commercial Real Estate (HVCRE) loans	100%	150%
Non-accruing & 90 days or more past due loans	100%	150%
Intangibles (MSA, DTA not deducted in defcap)	100%	250%
Securitizations	50%	75%
Derivatives	0%/ 20%/ 50%	0%/ 4%/ 10%
Fed Funds Sold and Securities Purchased to Resell	0%/ 20%/ 100%	0%/ 8%/ 40%
Securities Lent	0%/ 20%/ 50%/ 100%	0%/ 8%/ 20%/ 40%

Assumptions:

- 1-4 Family Mortgages: FDIC staff used data from Lender Processing Services (LPS) to estimate the risk-weight on the stock of residential mortgage loans in the banking industry. LPS collects data on mortgage originations, including some mortgage loan characteristics such as loan-to-value ratios.
- High-Volatility Commercial Real Estate (HVCRE) loans: HVCRE loans are a sub-set of commercial and land development (C&D) loans, which are reported on regulatory reports. FDIC staff estimated the amount of C&D loans classified as HVCRE by comparing Call Report and FFIEC 101 data.
- Non-Accruing and 90 day past due loans: FDIC staff used existing Call Report data on non-accruing and past due loans to assess the impact of a 150% risk weight.
- Intangibles: FDIC staff used existing Call Report data on intangible assets.
- Securitizations: FDIC staff assumed a 50% increase in the risk weight of securitization exposures based on Call Report data and discussions with bank examiners. FDIC staff assumed that the average risk weight for securitizations would increase because banks, particularly community banks, typically invest in senior tranches, whose risk-weight is less affected by the SSFA. In addition, the Standardized Approach includes the gross-up treatment which represents no change from current rules.
- Derivatives and Repo style transactions: FDIC staff estimates there will be a significant reduction in risk-weights for certain exposure under the collateral haircut approach and from the expansion of assets that would be recognized as eligible collateral under the proposal.



Statement of

James M. Garnett, Jr.

Head of Risk Architecture for Citi

on

The Impact of the Proposed Rules to Implement Basel III Capital Standards

Before the

Subcommittee on Financial Institutions and Consumer Credit

and the

Subcommittee on Insurance, Housing and Community Opportunity

of the

Committee on Financial Services

U.S. House of Representatives

November 29, 2012

Good morning, Chairman Capito, Chairman Biggert, and Members of the subcommittees on Financial Institutions and Consumer Credit and Insurance, Housing and Community Opportunity. My name is Jim Garnett, and I am the Head of Risk Architecture for Citi. In this capacity, I am responsible for implementing the Basel III capital rules for Citi within the United States and the other countries in which Citi operates around the globe. I want to thank you for holding a joint hearing on this very important topic.

Background

Citi today is among the best capitalized major banking institutions in the world, and we support strong capital requirements as one of the critical pillars of a safe, sound, and effective financial system. We have added over $140 billion in new capital to our capital base. Our capital strength is more than five times higher than it was during the crisis, and although the Basel III capital requirements do not fully kick in until January of 2019, Citi is well underway towards complying with them, both the baselines and surcharges. We are in a position to put our financial strength to work for our clients during challenging and uncertain economic times, and we are doing so.

In addition to increasing our capital, we have gone back to the basics of banking and have streamlined our company to focus on our core areas of strength – consumer banking and institutional banking including transaction services – with a clear structure and a clear strategy. Since 2009, we have invested in core businesses while reducing non-core assets. After completing more than 60 divestitures, we have reduced Citi Holdings by $600 billion and it now represents less than 10 percent of Citi's balance sheet. Our risk management has been completely overhauled and is a strong, independent function. Since the financial crisis, we have put in place a robust governance structure. We have significantly increased our liquidity resources; cash and available-for-sale securities represent 25 percent of the balance sheet; and

our available liquidity resources – cash and highly liquid securities – are in excess of $400 billion. By successfully executing our strategy, we have achieved sustainable earnings with 11 straight quarters of profitability. In short, we are now a simpler, smaller, safer, and stronger institution than we were a few years ago.

The Impact of Capital Rules Proposed by U.S. Banking Regulators

Citi broadly supports the goals of the Basel III capital rules proposed by the U.S. banking regulators. As a global bank, Citi has long supported risk-based capital standards along with heightened liquidity standards. We recognize the importance of capital to serve as a buffer against changing market and economic conditions. Aligning capital with economic risks ensures that adequate capital exists to cover risks and avoids excess capital, which can unnecessarily constrain lending and investment activities that support the real economy.

There are, however, certain features of the proposed rules that deserve refinement in order to avoid unintended, negative consequences. We are concerned that the cumulative capital levels will unnecessarily constrict credit for all but the nation's most credit-worthy borrowers. Additionally, we believe the elimination of the filter for accumulated other comprehensive income (AOCI) in calculating Tier 1 Common Equity will negatively impact the ability of banking organizations to extend new credit and cause banks to reduce investments in certain U.S. Treasury and agency debentures and mortgage-backed securities (MBS).

We are also concerned about the apparent lack of uniform application of capital and other supervisory standards within the U.S. and globally. U.S. and international banking regulators need to ensure that the Basel III rules are applied consistently and uniformly. Deviations in risk weighing should not be allowed.

Finally, we believe that capital rules should be tailored to different types and sizes of banks. We support a simpler set of risk-based rules for small, traditional community banks.

I will address each of these issues in the balance of my remarks.

Credit Availability

The financial crisis demonstrated a need for banks and other financial institutions to hold greater levels of capital. We support strong capital requirements and, as noted above, we have dramatically increased our capital since the crisis. At the same time, there is clearly a trade-off between higher capital and credit availability and cost. The obvious challenge is to find the right balance between capital levels necessary to withstand periods of economic stress and capital levels that do not choke off credit availability and investment.

We are concerned that under Basel III, consumers who do not have pristine credit histories will find credit to be less available and more expensive. This result will be particularly evident for consumers with weaker credit histories seeking residential mortgage loans or home equity lines of credit. Small business owners also will be adversely affected in the form of higher credit costs and constrained credit availability, particularly because small businesses do not have direct access to the capital markets - *i.e.*, they cannot borrow by issuing commercial paper or longer term notes and bonds, in contrast to the largest corporations who have the capital markets as an alternative source of credit. Basel III penalizes those who need credit the most across all institutions.

To help avoid capital standards that divide consumers between the "haves" and the "have nots," we support the industry's call for a quantitative impact study of the proposed rules. Such a study would enable Congress, the federal banking regulators, and others to better

understand the impact of the proposed rules and, if appropriate, to make adjustments that avoid an unintended contraction in credit to many customers.

AOCI Filter for Gains and Losses on Securities Available for Sale

In a major change from the current capital rules, the proposed rules would require unrealized gains and losses on securities that are held as "available for sale" by a bank to flow through to a bank's regulatory capital levels. Current capital rules impose a "filter" that prevents fluctuations in the value of such securities from passing through to regulatory capital. We believe that the elimination of this filter is ill-advised. The elimination of the filter will create inaccurate reports of actual capital strength; it will mean that capital will look like it is increasing as interest rates fall and decreasing as interest rates rise – but neither result will reflect reality.

Since fluctuations in interest rates impact the value of the securities held for sale, Citi and other U.S. banking organizations will be required to hold capital buffers to account for the potential swings in capital levels. This will exacerbate the aforementioned impacts of holding excessive capital in the banking system.

The removal of the filter also will cause Citi and other U.S. banking organizations to favor shorter duration securities over longer-dated Treasuries and MBS, because the value of shorter duration securities is less subject to swings in interest rates. This will inevitably impact the issuance and cost of Treasury securities and housing credit.

The removal of this filter will reduce a bank's flexibility in managing liquidity and diminish liquidity in the underlying debt markets. Additionally, the removal of the buffer provides a disincentive for prudent asset and liability management activities as banks will need to weigh the tradeoff between managing the risk of AOCI volatility and economic risk.

Finally, the removal of this filter will create an unlevel playing field between U.S. and foreign banks, since foreign banking organizations that follow international accounting standards are permitted to defer gains and losses by accounting for certain debt securities as loans.

We understand the rationale behind this proposed change given the credit related losses incurred during the recent crisis that were not reflected in capital. However, a better solution would be to continue to exclude unrealized gains and losses in Basel III Tier 1 Common Capital for available for sale securities of only the most creditworthy and liquid issuers. In other words, the filter should remain in effect for obligations issued or guaranteed by the U.S. government or government agencies. This approach would create consistency between the regulatory capital treatment of securities and the regulatory capital treatment of the deposit liabilities they are largely hedging, and it would reduce the negative consequences caused by volatility in regulatory capital levels.

Global Harmonization

One of the fundamental goals of the Basel Capital Accords is the harmonization of capital standards among industrialized countries. Having uniform and consistently applied capital standards ensures market confidence in banking organizations and promotes safety and soundness. Recently, however, regulators and investors have raised concerns about differences in risk-weighting systems used by banks in some countries. Asset risk-weights are a central feature of the Basel capital standards; they can determine how much – or how little – capital a bank needs to hold against a particular asset. It is imperative that U.S. and international banking regulators ensure that the Basel rules are applied uniformly and consistently by all banks. Otherwise, the integrity of the international capital standards will be compromised.

An unlevel Basel playing field across national jurisdictions can arise from two different sources. First, banking supervisors in different countries may apply different standards when approving internal models or internally calculated risk parameters. There is a great deal of concern that supervisors in some countries, like the U.S., will adhere to high standards of approval while those in other countries will adhere to laxer standards. An excellent method for determining if different supervisory standards are used is to require each bank to calculate the risk-weighted assets (RWA) of benchmark portfolios using the bank's current methods and assumptions. In fact, the Basel Committee's Standards Implementation Group has begun working on the use of benchmark portfolios to this end, as have some national regulators.

A second reason for an unlevel playing field could be that even if the Basel rules are adopted and implemented uniformly, a given rule can have a disparate impact across national jurisdictions because of differences in market structure and associated accounting standards across countries. For example, Mortgage Servicing Rights (MSRs) are a large asset for many U.S. financial institutions, from small community banks to larger multinational banks. Basel III initially excluded all MSRs from inclusion in Tier 1 Common. The final version of Basel III limited MSRs to only 10 percent of Tier 1 Common. MSRs are essentially only a U.S. bank issue. They arise from the combination of residential mortgage securitization and the details of generally accepted accounting principles (GAAP). Consequently, the limitation on the recognition of MSRs essentially only affects U.S. banks.

Community Banks

We believe there is a good case for applying a more simplified risk-based capital regime than the Basel III rules for small community banks. While the Basel I regime is overly simplistic for large banks, it can be an effective capital regime for smaller, community banks that do not have complex balance sheets. These types of traditional community banks primarily make

commercial real estate and residential real estate loans, automobile and other consumer loans, and business loans. They also have investment portfolios that are largely composed of Treasury securities and MBS. They do not need the highly granular risk categories proposed in Basel III.

Basel III also poses greater operational and compliance challenges for community banks than for large banks. Basel III is a comprehensive rewrite of the capital rules, and compliance with these rules carries significant costs. Large banks, like Citi, already have incurred many of these costs in preparation for Basel II. Large banks also enjoy economies of scale in technology and systems. Community banks are justifiably concerned about the compliance costs imposed by Basel III. The federal banking regulators should reconsider the application of Basel III to traditional community banks that do not have complex balance sheets and permit such institutions to continue to comply with Basel I or some other simplified risk-based capital regime.

Conclusion

Thank you again for the opportunity to appear before the subcommittees to discuss some refinements to the Basel III rules that we believe are needed to avoid unintended, negative consequences.

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Statement by

Michael S. Gibson

Director

Division of Banking Supervision and Regulation

Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions and Consumer Credit

and

Subcommittee on Insurance, Housing, and Community Opportunity

U. S. House of Representatives

November 29, 2012

Chairman Capito, Chairman Biggert, Ranking Member Maloney, Ranking Member Gutierrez, and members of the subcommittees, thank you for the opportunity to testify on the proposed interagency changes to the regulatory capital framework for U.S. banking organizations. In today's testimony, I will provide an overview of the proposed changes and the main themes arising from the public comment process, especially as they relate to community banking organizations and depository institution holding companies with insurance activities.

Overview of Proposed Changes

The recent financial crisis revealed that the amount of high-quality capital held by banking organizations in the United States was insufficient to absorb losses during periods of severe stress. The effects of having insufficient levels of capital were further magnified by the fact that some capital instruments did not absorb losses to the extent previously expected. While robust bank capital requirements alone cannot ensure the safety and soundness of the banking system, we believe they play a key role in protecting the banking system and financial stability more broadly.

As demonstrated during the recent financial crisis, banking organizations with strong capital positions are better equipped to absorb losses from unexpected sources. Furthermore, strong capital positions help to ensure that bank losses are borne by shareholders, rather than taxpayers. The June 2012 interagency proposal to amend the bank regulatory capital framework applies the lessons of the crisis, in part, by increasing the quantity and quality of capital held by banks.[1] For all banking organizations, the proposal would introduce a new common equity tier 1 capital requirement, raise existing minimum tier 1 capital requirements, and implement a capital conservation buffer to increase bank resiliency during times of stress. The proposal also updates and harmonizes the existing capital rules with a standardized approach for the calculation of risk-

[1] *See* press release and proposal, www.federalreserve.gov/newsevents/press/bcreg/20120612a.htm.

weighted assets, incorporating a more risk-sensitive treatment for certain asset classes to address weaknesses identified in the capital framework in recent years.

For large, internationally active organizations, the proposal would introduce a supplementary leverage ratio, a countercyclical capital buffer, and would effectively raise the capital requirement by updating aspects of the advanced approaches risk-based capital rule. These amendments, along with other recent regulatory capital enhancements, will require the large, systemically important banking organizations to hold significantly higher levels of capital relative to other institutions. Under the proposal, savings and loan holding companies would, for the first time, be subject to consolidated capital requirements, as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). With this proposal, U.S. bank capital requirements would reflect international Basel III agreements reached by the Basel Committee on Banking Supervision as well as relevant domestic legislative provisions, including sections 171 and 939A of the Dodd-Frank Act.

In developing this proposal, the Federal Reserve sought to strike the right balance between safety and soundness concerns and the regulatory burden associated with implementation, including the impact on community banking. It is important to note that numerous items in this proposal, and in other recent regulatory reforms, are focused on larger institutions and would not be applicable to community banking organizations. These items include the countercyclical capital buffer, the supplementary leverage ratio, enhanced disclosure requirements, the advanced approaches risk-based capital framework, stress testing requirements, the systemically important financial institution capital surcharge, and market risk capital reforms.

Impact

The Federal Reserve has assessed the impact of the changes proposed by this rulemaking on banking organizations and the broader financial system through domestic analyses and through its participation in cost-benefit analyses performed by the Basel Committee on Banking Supervision. The Macroeconomic Assessment Group, a working group of the Basel Committee, found that among internationally active banks, the stronger capital standards proposed under Basel III would significantly lower the probability of banking crises and their associated economic losses, while having only a modest negative effect on gross domestic product and the cost of credit.[2] Furthermore, these modest negative effects can be mitigated by the phase in of the standards over time, which is why we have included extensive transition periods for several aspects of the proposal. The Federal Reserve believes that the benefits of the proposed changes, in terms of the reduction of risk to the U.S. financial system and to the broader economy, outweigh the compliance costs to the financial industry and any costs to the macroeconomy.

In developing the proposal, each of the federal banking agencies prepared an impact analysis of the proposed requirements on banking organizations that currently meet the minimum regulatory capital requirements, based on each agency's own key assumptions using regulatory reporting data. The Federal Reserve's analysis and assumptions are included as an attachment to today's testimony.[3] The overall conclusion of these analyses was that the vast majority of banking organizations would not be required to raise additional capital because they already meet, on a fully phased-in basis, the proposed higher minimum requirements. In addition,

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[2] *See* "Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements" (August 2010), www.bis.org/publ/othp10.pdf; and "An assessment of the long-term economic impact of stronger capital and liquidity requirements" (August 2010), http://www.bis.org/publ/bcbs173.pdf.

[3] *See* Attachment A - FRB Impact, Methodology, and Assumptions.

approximately 90 percent of community banking organizations already have sufficient capital to meet or exceed the proposed buffer, thus avoiding restrictions on capital distributions and certain executive bonus payments. While many of the largest banking organizations do not already meet the proposed new minimums and the buffer on a fully phased-in basis, they are generally making steady progress toward meeting these standards before they are phased in. However, the Federal Reserve is mindful that other burdens exist for banks, such as systems changes and other compliance costs, which were outside the scope of our analysis.

Public Comments on the Proposed Changes

The federal banking agencies released the proposed rulemaking in early June with an extended comment period ending on October 22, giving interested parties more than four months to comment on the proposal rather than the typical two- or three-month comment period. The agencies have received thousands of comment letters from the public, including banking organizations of all sizes, trade groups, academics, public interest advocates, and private individuals.[4] Agency staffs are reviewing these letters carefully and will continue to do so in the coming weeks. Comments include general views on the proposal, including concerns regarding overall complexity and burden, as well as suggestions for specific policy changes and technical modifications aimed at better conforming the proposal to market practices.

The most common specific areas of concern noted by the financial industry, regardless of institution size, relate to the proposed treatments of accumulated other comprehensive income, otherwise known as AOCI, and residential mortgage exposures. The proposed treatment of AOCI would require unrealized gains and losses on available-for-sale securities to flow through to regulatory capital as opposed to the current treatment, which neutralizes such effects.

[4] *See* comment letters, www.federalreserve.gov/apps/foia/ViewComments.aspx?doc_id=R-1442&doc_ver=1.

Commenters have expressed concern that this treatment would introduce capital volatility, due not only to credit risk but also to interest rate risk, and affect the composition of firms' securities holdings. The proposed treatment of AOCI is part of the Basel III Accord and is meant to better reflect an institution's actual loss-absorption capacity; however, we are analyzing commenters' concerns and will be assessing potential ways forward in this area as we finalize the rule.

In light of observed high loss rates for residential mortgages during the crisis, the agencies proposed a modified treatment aimed at better differentiating the risks of these exposures, which are generally assigned preferential risk weights under our current approach. Commenters have expressed concern that the operational burden and compliance costs of the proposed methodology for risk weighting residential mortgage exposures and the higher risk weights for certain types of mortgage products will increase costs to consumers and reduce their access to mortgage credit. The Federal Reserve, along with the other federal banking agencies, will take these and all comments received into consideration as we finalize the rule.

Community Banks

The Federal Reserve believes capital requirements that improve the quantity and quality of regulatory capital would benefit the resiliency of all banking organizations regardless of size. However, as we consider comments from industry participants and other interested parties regarding the proposed regulatory capital requirements, the Federal Reserve, along with the other federal banking agencies, will remain sensitive to concerns expressed by community banking organizations. The Board recognizes the vital role that community banking organizations play in the U.S. financial system. Community bankers typically have deep roots in their communities, allowing them to gain insights on their local economies and to forge strong relationships with

customers. As a result, they can provide relationship-based lending to small businesses, families, and others in their local communities in a manner that larger institutions would find difficult to duplicate.

When the agencies were developing these proposals, we recognized the need to carefully assess their impact on community banking organizations. While we conducted internal analysis to estimate the impact of the proposal (as discussed earlier), the Federal Reserve also recognized the importance of soliciting feedback directly from community banking organizations to understand more specifically the potential effects on their business activities. To facilitate review of the proposal, the agencies provided summaries of the requirements that were most relevant for community banking organizations, provided a tool to help smaller organizations estimate their capital levels under the proposal, and extended the comment period so that interested parties would have more time to assess the proposals and submit their comments. The Federal Reserve also engaged in substantial industry outreach to hear the views of community bankers and encourage submission of comments. For example, we held a series of "Ask the Fed" sessions aimed primarily at banking organizations supervised by the Federal Reserve that provided an overview of the proposals and gave bankers an opportunity to ask us questions. Following these sessions, which were attended by more than 3,000 bankers, we published a summary of answers to frequently asked questions in a new Federal Reserve publication for community bankers.[5] Throughout the comment process, Board members and staff also met with various industry associations to clarify and discuss aspects of the proposal.

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[5] *See* "Community Banking Connections: A Supervision and Regulation Publication" (Third Quarter, 2012), www.communitybankingconnections.org/articles/2012/Q3/CBCQ32012.pdf.

Through outreach efforts and as part of the comment process, community banking organizations have expressed concerns about particular elements of the proposed requirements, indicating that they do not adequately take into account the community banking business model and that some aspects would have potential disproportionate effects on their organizations. In particular, they have asserted that the proposed treatment of AOCI would have more of an impact on community banks because they have fewer available strategies to address the resultant capital volatility relative to larger institutions. In addition, they have expressed concern that the relatively higher risk weights assigned to certain mortgage products would penalize loan products that community banking organizations typically provide their customers. We will be mindful of these comments when considering potential refinements to the proposal and will work to appropriately balance the benefits of a revised capital framework against its costs. As we work toward finalizing the rule, we will seek to further tailor the requirements as appropriate for community banking organizations.

Insurance Holding Companies

The proposal would apply consolidated risk-based capital requirements that measure the credit and market risk of all assets owned by a depository institution holding company and its subsidiaries, including assets held by insurance companies. In addition, the proposal would capture the risk of insurance underwriting activities included in the consolidated holding company capital requirements by requiring deduction of the minimum regulatory capital requirement of the relevant state regulator for insurance companies in the consolidated group. Currently, capital requirements for insurance companies are imposed by state insurance laws on

a legal entity basis and there are no state-based, consolidated capital requirements that cover the subsidiaries and non-insurance affiliates of insurance companies.

The proposed capital requirements have been criticized by savings and loan holding companies that are not currently subject to consolidated capital requirements and that have significant insurance activities. Before mentioning some of the concerns raised by the industry, I would like to provide some background regarding the policy rationale for this proposal. The proposed application of consolidated capital requirements to savings and loan holding companies is consistent with the Board's long-standing practice of applying consolidated minimum capital requirements to bank holding companies, including those that control functionally regulated subsidiary insurance companies. Importantly, such an approach eliminates incentives to engage in capital arbitrage by booking individual exposures in the legal entity in which they receive the most favorable capital requirement.

The proposed requirements are also consistent with the Collins Amendment in section 171 of the Dodd-Frank Act, which requires that the agencies establish consolidated minimum risk-based and leverage requirements for depository institution holding companies (bank holding companies and savings and loan holding companies) that are no less than the generally applicable risk-based capital and leverage requirements that apply to insured depository institutions under the prompt corrective action framework. At the same time, the proposal included provisions assigning specific risk weights to assets typically held by insurance companies but not depository institutions, namely policy loans and non-guaranteed separate accounts. These provisions were designed to appropriately risk weight assets particular to the insurance industry while at the same time ensuring that the proposals complied with section 171

of the Dodd-Frank Act and fulfilled the policy goals for consistent consolidated capital requirements previously described.

Through the comment process, depository institution holding companies with insurance activities raised overarching concerns that the proposed regulatory capital requirements, which have primarily been developed for banking organizations, are not suitable for the insurance business model. In particular, they assert that the proposal does not appropriately recognize the longer-term nature of their liabilities and their practice of matching asset and liability maturities. They also assert that the proposal would disproportionately affect longer term assets held by many insurance companies, thus causing them to fundamentally alter their business strategy. These holding companies also have requested a longer transition period to implement consolidated capital requirements for the first time. Currently, those savings and loan holding companies that are also insurance companies report financial statements to state insurance regulators according to Statutory Accounting Principles and would have to begin reporting under the Generally Accepted Accounting Principles to comply with consolidated regulatory capital requirements, a change they assert would be unreasonably costly.

The Federal Reserve takes these comments seriously and will consider them carefully in determining how to appropriately apply regulatory capital requirements to depository institution holding companies with significant insurance activities.

Timeline

Given the breadth of the proposed changes, many industry participants have expressed general concern that they may be subject to a final regulatory capital rule on January 1, 2013, as contemplated in the proposals, and that this would not provide sufficient time to understand the

rule or to make the necessary systems changes. Therefore, the agencies clarified on Friday that they do not expect to finalize the proposal by January 2013.[6] We are working as quickly as possible to evaluate comments and issue a final rule that would provide the industry with appropriate transition periods to come into compliance.

Thank you. I would be pleased to take your questions.

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[6] *See* "Agencies Provide Guidance on Regulatory Capital Rulemakings," www.federalreserve.gov/newsevents/press/bcreg/20121109a.htm.

Top-tier BHCs that meet tier 1 minimums under the current and proposed rule
Data as of March 31, 2012

Current rules (Basel I)

BHC total asset size	>= $500m and < $10b	>$10 b	Total
Total # top-tier BHCs	877	78	955
Number of BHCs that meet 4% tier 1 minimum today	859	77	936
%	98%	99%	98%
Avg $ amount of tier 1 in excess of minimum ($000s)	$111,428	$10,479,898	
Avg multiple of tier 1 held / tier 1 required	3.8	3.6	

Proposed rule (Basel III)

BHC total asset size	>= $500m and < $10b	>$10 b	Total
Total # top-tier BHCs	877	78	955
Number of BHCs that meet 6% tier 1 minimum as proposed	810	74	884
%	92%	95%	93%
Average $ amount of tier 1 in excess of minimum ($000s)	$71,715	$5,658,259	
Average multiple of tier 1 held / tier 1 required	2.1	1.9	

Top-tier BHCs that do not meet tier 1 minimums under the current and proposed rule
Data as of March 31, 2012

Current rules (Basel I)

BHC total asset size	>= $500m and < $10b	>$10 b	Total
Total # top-tier BHCs	877	78	955
Number of BHCs that do not meet 4% tier 1 minimum today	18	1	19
%	2%	1%	2%
Average $ amount of tier 1 shortfall of minimum ($000s)	-$34,766	-$497,448	
Aggregate $ amount of tier 1 shortfall of minimum ($000s)	-$625,791	-$497,448	

Proposed rule (Basel III)

BHC total asset size	>= $500m and < $10b	>$10 b	Total
Total # top-tier BHCs	877	78	955
Number of BHCs that do not meet 6% tier 1 minimum as proposed	67	4	71
%	8%	5%	7%
Average $ amount of tier 1 shortfall of minimum ($000s)	-$32,716	-$688,217	
Aggregate $ amount of tier 1 shortfall of minimum ($000s)	-$2,191,942	-$2,752,868	

Proposed rule (Basel III) excluding those who fail tier 1 min today

BHC total asset size	>= $500m and < $10b	>$10 b	Total
Total # top-tier BHCs	877	78	955
Tier 1			
Number of BHCs that do not meet 6% tier 1 minimum as proposed	49	3	52
% of total	6%	4%	5%
Average $ amount of tier 1 shortfall of minimum ($000s)	-$17,124	-$309,260	
Aggregate $ amount of tier 1 shortfall of minimum ($000s)	-$839,087	-$927,781	
Common equity tier 1 (CET1)			
Number of BHCs that do not meet 4.5% CET1 minimum as proposed	54	1	55
% of total	6%	1%	6%
Average $ amount of CET1 4.5% shortfall of minimum ($000s)	-$15,355	-$21,888	
Aggregate $ amount of CET1 4.5% shortfall of minimum ($000s)	-$829,181	-$21,888	
Number of BHCs that do not meet 7% CET1 minimum as proposed	150	8	158
% of total	17%	10%	17%
Average $ amount of CET1 7% shortfall of minimum ($000s)	-$23,483	-$752,523	
Aggregate $ amount of CET1 7% shortfall of minimum ($000s)	-$3,522,450	-$6,020,186	

Banks that meet tier 1 minimums under the current and proposed rule
Data as of March 31, 2012

Current rules (Basel I)			
Bank total asset size	< $10b	>=$10b	Total
Total # banks	7,269	107	7,376
Number of banks that meet 4% tier 1 minimum today	7,213	107	7,320
% of total	99%	100%	99%
Avg $ amount of tier 1 in excess of minimum ($000s)	$30,110	$6,055,069	
Avg multiple of tier 1 held / tier 1 required	5.7	4.1	

Proposed rule (Basel III)			
Bank total asset size	< $10b	>=$10b	Total
Total # banks	7,269	107	7,376
Number of banks that meet 6% tier 1 minimum as proposed	7,094	106	7,200
% of total	98%	99%	98%
Average $ amount of tier 1 in excess of minimum ($000s)	$24,184	$4,153,418	
Average multiple of tier 1 held / tier 1 required	3.7	2.4	

Banks that do not meet tier 1 minimums under the current and proposed rule
Data as of March 31, 2012

Current rules (Basel I)			
Bank total asset size	< $10b	>=$10b	Total
Total # banks	7,269	107	7,376
Number of banks that do not meet 4% tier 1 minimum today	56	0	56
% of total	1%	0%	1%
Average $ amount of tier 1 shortfall of minimum ($000s)	-$2,344	$0	
Aggregate $ amount of tier 1 shortfall of minimum ($000s)	-$131,254	$0	

Proposed rule (Basel III)			
Bank total asset size	< $10b	>=$10b	Total
Total # banks	7,269	107	7,376
Number of banks that do not meet 6% tier 1 minimum as proposed	175	1	176
% of total	2%	1%	2%
Average $ amount of tier 1 shortfall of minimum ($000s)	-$5,303	-$106,263	
Aggregate $ amount of tier 1 shortfall of minimum ($000s)	-$928,108	-$106,263	

Proposed rule (Basel III) excluding those who fail tier 1 min today			
Bank total asset size	< $10b	>=$10b	Total
Total # banks	7,269	107	7,376
Tier 1			
Number of banks that do not meet 6% tier 1 minimum as proposed	119	1	120
% of total	2%	1%	2%
Average $ amount of tier 1 shortfall of minimum ($000s)	-$4,273	-$106,263	
Aggregate $ amount of tier 1 shortfall of minimum ($000s)	-$508,437	-$106,263	
Common equity tier 1 (CET1)			
Number of banks that do not meet 4.5% CET1 minimum as proposed	59	0	59
% of total	1%	0%	1%
Average $ amount of CET1 4.5% shortfall of minimum ($000s)	-$6,694	$0	
Aggregate $ amount of CET1 4.5% shortfall of minimum ($000s)	-$394,934	$0	
Number of banks that do not meet 7% CET1 minimum as proposed	187	2	189
% of total	3%	2%	3%
Average $ amount of CET1 7% shortfall of minimum ($000s)	-$6,206	-$196,296	
Aggregate $ amount of CET1 7% shortfall of minimum ($000s)	-$1,160,524	-$392,592	

ATTACHMENT A

Impact Analysis Methodology for Basel 3 NPRs

- Staff conducted an analysis to assess the impact of the proposed changes to the definition of capital (Basel III NPR) and to risk-weighted assets (Standardized Approach NPR) for banks and top-tier bank holding companies using available data, as of March 31, 2012, from the commercial bank Call Reports and the holding company FR Y-9C reports. Because required data was not always available, staff made certain assumptions (listed below) to calculate the Basel III requirements.

Definition of capital (numerator of risk-based capital ratios)

- With respect to the regulatory deductions from capital, staff made assumptions regarding the amount of:
  - outstanding DTAs subject to full deduction and the amount subject to the threshold deductions;
  - investments in the capital of unconsolidated financial institutions subject to the threshold deductions; &
  - common equity tier 1 and tier 1 minority interest based on outstanding Class A minority interest.

Standardized approach risk-weighted assets (denominator of risk-based capital ratios)

- To estimate Basel III risk-weighted assets, staff used line items from the Call Report and Y-9C to estimate changes in the risk-weighted asset amount for residential mortgage exposures, high-volatility commercial real estate (HVCRE) exposures, past-due loans, and securitizations.
- The risk weight for HVCRE exposures (defined as construction, land development, and other land loans for this analysis; available on the regulatory reports) was increased from a risk-weight of 100% to 150%.
- Residential Mortgage Exposures
  - First-lien residential mortgage exposures as reported on the regulatory reports (currently risk weighted at 50%) were assumed to be category 1 exposures, while junior lien exposures, including home equity lines of credit, (currently risk-weighted at 100%) were assumed to be category 2 exposures.
  - To distribute residential mortgages across the proposed risk weights, which are based on LTV, an LTV distribution for firms' first and second lien mortgage portfolios was estimated using loan LTV data from industry databases (McDash and Corelogic) and then spread across the Category 1 risk weights (35% to 100%) and Category 2 risk weights (100% to 200%), as appropriate.
- Past-due loans (loans past due 90 days or more and nonaccrual loans, excluding residential mortgages and sovereign exposures), which currently are risk-weighted at 100%, were assigned to the 150% risk weight.
- For foreign sovereign exposures, used the public cross-border claims and the foreign-office claims on local residents in non-local currency from the FFIEC 009 report to find a distribution of foreign sovereign exposures by country, which was assumed to be representative across all institutions. Assigned risk weights by country: under Basel I, OECD countries received a zero percent risk weight, while all other countries received a 100% risk weight; under Basel III, assigned countries risk weights according to their CRC ratings. Applied country distribution, with associated risk weight, to foreign debt securities line items from the regulatory report.
- Securitization exposures
  - An interagency analysis was conducted using the simplified supervisory formula approach to calculate risk weights on tranches within 60 securitization transactions downloaded from an industry database (Intex) 15 deals each were selected for credit cards, autos, residential mortgages, and commercial mortgages.
  - To calculate average risk weights under Basel I, each tranche of the selected transactions was assigned a risk weight according to the general risk-based capital rules with certain assumptions. As a result, certain exposures were assigned risk weights according to the ratings-based approach, most mezzanine and junior positions were assumed to receive a 1,250% under the gross-up approach, and low-rated senior positions were assigned a 100% risk weight. To calculate average risk weights under Basel III, the SSFA was applied to each tranche of the selected transactions.
  - The current balance of each transaction was used to calculate a weighted average risk weight across each transaction type. These risk weights were then applied to each bank's value of summed items from the regulatory report for RMBS, CMBS, auto, and credit card.

I. Steps for estimating the numerator changes for the capital ratios under the Basel 3 proposal

Staff from an inter-agency work group used both qualitative measures (such as discussions with banks), as well as quantitative measures (such as QIS data) to create the assumptions used to estimate capital as proposed in the Basel 3 NPRs.

The assumptions include:

- 40% of a bank's deferred tax assets (DTAs) are used as a proxy for "carry-forward DTAs," which would be subject to full deduction
- 60% of DTAs are used as a proxy for "temporary differences DTAs," which would be subject to strict limits
- 80% of qualifying non-controlling (minority) interests in consolidated subsidiaries is used as a proxy for qualifying "common equity tier 1 minority interest"
- 20% of qualifying non-controlling (minority) interests in consolidated subsidiaries is used as a proxy for qualifying "tier 1 minority interest"
- 40% of investments in unconsolidated subsidiaries and associated companies is used as a proxy for "significant investments in unconsolidated financial institutions in the form of common stock"
- Regarding tier 1 deductions resulting from the corresponding deduction approach, trust preferred securities issued by financial institutions are used as a proxy for investments in the capital of unconsolidated financial institutions

1. Basel 3 Common equity tier 1 (CET1) calculation

The following items from the regulatory reports were used in the Basel 3 CET1 numerator calculations:

Item	Banks (Call Report)	BHCs (Y-9C)
Common stock	RCFD3230	BHCK3230
Surplus	RCFD3839	BHCK3240
Retained Earnings	RCFD3632	BHCK3247
AOCI	RCFDb530	BHCKb530
Other equity capital components	RCFDa130	BHCKa130
Qualifying non-controlling (minority) interests in consolidated subsidiaries	RCFDb589	BHCKG214
Goodwill	RCFDb590	BHCKb590
Cumulative change in fair value of all financial liabilities accounted for under a fair value option that is included in retained earnings and is attributable to changes in the bank's own creditworthiness	RCFDf264	BHCKf264
Purchased credit card relationships and nonmortgage servicing assets	RCFDb026	BHCKb026
Net deferred tax assets	RCFD2148	BHCK2148
Investments in unconsolidated subsidiaries and associated companies	RCFD2130	BHCK2130
Mortgage servicing assets	RCFDa590	BHCK6438

The Basel 3 CET1 base

The Basel 3 CET1 base used for the 10 and 15% threshold limitations described below is calculated by adding common stock, surplus, retained earnings, AOCI, other equity capital components, and 80% of qualifying non-controlling (minority) interests in consolidated subsidiaries (CET1 minority interest). Subtracted from that value is goodwill, the cumulative change in fair value of financial liabilities, the purchased credit card relationships and nonmortgage servicing assets, and the 40% of DTAs ("carry-forward DTAs").

The 10 and 15% threshold limitations on MSAs, DTAs, and significant investments in unconsolidated subsidiaries in the form of common stock

The 10% potential deduction for MSAs, "temporary differences DTAs" and significant investments in unconsolidated financial institutions in the form of common stock is calculated using the CET1 base described above.

The 15% limitation for MSAs, "temporary differences DTAs" and significant investments in unconsolidated financial institutions in the form of common stock is equal to 17.65% of the Basel 3 CET1 base, less the sum of the 10% deductions described above.

Basel 3 CET1 capital calculation

Basel 3 CET1 is equal to the Basel 3 CET1 base, less deductions resulting from the 10% limitations, less deductions resulting from the 15% limitation described above.

2. Basel 3 Tier 1 capital calculation

The following items from the regulatory reports were used in the Basel 3 tier 1 numerator calculations:

Item	Banks (Call Report)	BHCs (Y-9C)
Perpetual preferred stock and related surplus	RCFD3838	BHCK3283
Non-qualifying perpetual preferred stock	RCFDb588	BHCKb588
Qualifying non-controlling (minority) interests in consolidated subsidiaries	RCFDb589	BHCKG214
Trust preferred securities issued by financial institutions (HTM fair value from HC-B)	RCFDg349	BHCKg349
Trust preferred securities issued by financial institutions (AFS fair value from HC-B)	RCFDg351	BHCKg351
Trust preferred securities issued by financial institutions (consolidated from HC-D)	RCFDg299	BHCKg299

Basel 3 tier 1 capital calculation

Basel 3 tier 1 capital is estimated to be equal to the Basel 3 CET1 base plus perpetual preferred stock and related surplus, plus tier 1 minority interest, less non-qualifying perpetual preferred stock and less any amount of investments in the capital of unconsolidated financial institutions above the 10% threshold limitation.

2. Basel 3 Tier 2 and total capital calculation

The following items from the regulatory reports were used in the Basel 3 tier 2 and total capital numerator calculations:

Item	Banks (Call Report)	BHCs (Y-9C)
Qualifying subordinated debt and redeemable preferred stock	RCFD5306	BHCKg217
Cumulative perpetual preferred stock includible in Tier 2 capital	RCFDb593	BHCKg218
Allowance for loan and lease losses includible in Tier 2 capital	RCFD5310	BHCK5310
Qualifying restricted core elements (other than cumulative perpetual preferred stock)		BHCKg215
Unrealized gains on AFS equity securities includable in Tier 2 capital	RCFD2221	BHCK2221
Other Tier 2 capital components	RCFDb594	BHCKb594

Basel 3 tier 2 capital calculation

Basel 3 tier 2 is calculated by adding qualifying subordinated debt and redeemable preferred stock, cumulative perpetual preferred stock includible in tier 2 capital, allowance for loan and lease losses includible in tier 2 capital, unrealized gains on available-for-sale securities includable in tier 2 capital, other tier 2 capital components, and qualifying restricted core elements (other than cumulative perpetual preferred stock), which is the value of the trust-preferred securities that were removed from tier 1 capital.

Basel 3 total capital calculation

Basel 3 total capital is calculated by adding tier 1 and tier 2 capital as described above.

II. Steps for estimating the denominator changes for the capital ratios under the Basel 3 proposal (standardized approach)

To determine the impact of the changes to risk-weighted assets under the standardized approach, staff used existing risk-weighted assets (less numerator deductions), and then added the Basel III "impact" for the following categories: foreign sovereign exposures, foreign DI exposures, high volatility commercial real estate (HVCRE), past-due loans, residential mortgage exposures, and securitization exposures.

1. "Base" risk-weighted assets and risk-weighted asset impact by category

The "base" (reported) risk-weighted asset value for each bank was first adjusted to reflect any of the capital deductions described in part I (numerator changes). Staff then estimated a change in risk-weighted assets for each category (foreign sovereign exposures, foreign DI exposures, HVCRE, past-due loans, residential mortgage exposures, and securitization exposures) by pulling line items for each category, and comparing the risk-weighted exposure amount under Basel I versus under Basel III.

A. Foreign Sovereign Exposures.

1) Sum line items RCFD 1742, RCFD 1744, and RCFD 2081 for each bank, finding one value, "sovereign amount" per bank.

2) Sum the exposure amounts from 009 Report line items FCEX C916 and C919 for each country. Find the % by country by dividing total for country over total exposures for all countries for FCEX C916 and C919. Will have one % for each country. This "distribution" will be used for all banks and bank holding companies.

For this analysis:

- Removed countries where there were no exposure values
- Removed lines that were regions or sums of countries (ie only included individual country data)

3) Find appropriate risk weight under Basel I and Basel III per country as outlined below:

Basel I (baseline)

4) Exposures to OECD member countries receive a zero percent risk weight, while exposures to all other countries receive a risk weight of 100 percent. Multiply applicable risk weight (zero or 100) by exposure amount per country. Sum the amounts per country, per bank to find risk-weighted exposure amount by asset size group.

Basel III

CRC Ratings	Risk Weight
0-1	0%
2	20%
3	50%
4-6	100%
7	150%
No CRC	100%

4) Use CRC table to find appropriate risk weight per country. Multiply risk weight by the distribution percentage found in step 2; then multiply by exposure amount per bank.

B. Foreign DI Exposures.

1) Pull line RCFD B532 for each bank as "foreign DI amount."

2) Sum the exposure amounts from 009 Report line items FCEX C915 and C918 for each country. Find the % by country by dividing total for country over total exposures for all countries for FCEX C915 and C918. Will have one % for each country. This "distribution" will be used for all banks and bank holding companies.

3) Find appropriate risk weight under Basel I and Basel III per country as outlined below:

Basel I (baseline)
4) Foreign DI exposures to OECD member countries receive a 20 percent risk weight, while exposures to all other countries receive a risk weight of 100 percent. Multiply applicable risk weight (20 or 100) by exposure amount per country.

Basel III

4) Use CRC table below to find appropriate risk weight per country. Multiply risk weight by the distribution percentage found in step 2; then multiply by exposure amount per bank.

CRC of Sovereign Incorporation	Risk Weight (%)
0-1	20
2	50
3	100
4-7	150
No CRC	100

C. High Volatility Commercial Real Estate (HVCRE)

Steps for analysis:

1) Pull line item RCONf159 by bank as "HVCRE."

Basel I
2) HVCRE under Basel I is 100% risk-weighted.

Basel III
2) HVCRE under Basel III is 150% risk-weighted.

D. Past-due loans

Steps for analysis:

1) Sum line items: rcfdf171 rcfdf170 rcfd5461 rcfd5460 rcfd1256 rcfd1255 rcfd1253 rcfd1252 rconc229 rconc237 rconc230 rconc239 rcfdf167 rcfd1597 rcfd5391 rcfd5390 rcfd5382 rcfd5381 rcfd5379 rcfd5378 rcon3495 rcon3494 rconf183 rconf181 rconf180 rconf182 rcfnb574 rcfnb573 rcon5400 rcon5399 rcon3501 rcon3500 rcfd1583 rcfdk215 rcfdk214 rcfdk217 rcfdk218 rcfdb577 rcfdb576 rcfd3506 rcfd3507 rconf177 rconf175 rcfdf168 rconf176 rconf174) as "Past Due Loans" per bank.

Basel I
2) Past Due loans under Basel I are 100% risk-weighted.
Basel III

2) Past Due loans under Basel III are 150% risk-weighted.

E. Residential Mortgage Exposures.

Steps for analysis:

1) Pull line item RCON 5367 (first liens) per bank as "RCON 5367." Sum line items RCON 1797 and RCON 5368 (junior and revolving liens) for each bank as "RCON 1797+RCON 5368."

Basel I
2) Multiply "RCON 5367" by 50% (RW); multiply " RCON 1797 +RCON 5368" by 100% (RW). Sum these values by bank to find the risk-weighted exposure amount for residential mortgages.

Basel III
2) Distribute "RCON 5367" according to table and multiply that amount by appropriate risk weight, per the table. Sum the values by bank. Note for this analysis, used the original LTV category (per ALH). Distributions for Category 1 and Category 2 loans are based on analysis from Paul Calem (document titled "ltv distributions.txt").

Original LTV Category	80% of First liens are Category 1	Category 1 risk weight	20% of First liens are Category 2	Category 2 risk weight
<= 60	32.73	35%	4.02	100%
> 60 and <= 80	60.81	50%	18.04	100%
> 80 and <= 90	2.89	75%	26.44	100%
>90	3.58	100%	51.5	200%

3) Distribute "RCON 1797 +RCON 5368" according to table and multiply that amount by appropriate risk weight, per the table.

LTV Category	Percent of principal balance by category	Category 2 residential mortgage exposure risk weights
<= 60	22%	100%
> 60 and <= 80	40%	100%
> 80 and <= 90	24%	150%
> 90	14%	200%
Total	100%	

F. Securitization Exposures.

Approach: The New York RB and the Philadelphia RB provided a file of anonymized securitization data from large banking organizations across five product types (CLOs, non-agency RMBS, Credit Card, Auto, and CMBS) with the necessary data points including an external rating, attachment point and detachment points, and cumulative loss data. For each of these product types, risk weights were

calculated for 25 securities under the Baseline and the SSFA. The average risk weights under the Baseline and the SSFA for these securities were used as a proxy to estimate the impact.

1. For each product type, provide the weighted average for the Baseline RW and the SSFA risk weight.

Type	Baseline Ave RW (Basel I treatment)	SSFA Ave RW (Basel III treatment)
Credit Cards	109%	170.4%
Autos	52%	67%
CMBS	164%	239.5%
RMBS*	365%	445%

*to find Basel I risk weight for RMBS, using interagency-supplied securitization data:

1) Used "current" cycle date data only
2) anything with a detachment point of 100 (senior) got 100% risk weight, all else got 1250% as "B1 risk weight"
3) used current bal to find a weight per transaction
4) multiplied weight by B1 risk weight; summed risk weights to find one weighted average risk weight

2. Baseline reporting line items:

Type	Baseline Call Report Line Items	Baseline BHC Line Items
Credit Cards	RCFD B838, RCFD B841	BHCK B838, BHCK B841
Autos	RCFD B846, RCFD B849	BHCK B846, BHCK B849
CMBS	RCFD K146 RCFD K149, RCFD K154, RCFD K157	BHCK K146, BHCK K149, BHCK K154, BHCK K157
RMBS	RCFD G308, RCFD G311, RCFD G320, RCFD G323	BHCK G308, BHCK G311, BHCK G320, BHCK G323,

3. For each product type, aggregate and average the Call Report line items and apply the Baseline (Basel 1) risk weights and SSFA risk weights (Basel 3).

3. Calculate impact and Basel III risk-weighted assets

For each category (foreign sovereign exposures, foreign DI exposures, HVCRE, past-due loans, residential mortgage exposures, and securitization exposures), multiplied the line items from the regulatory reports first by the risk weight for Basel I, which represented the risk-weighted assets under Basel I for that category. This step was replicated for Basel III by multiplying the line items from the regulatory reports by the risk weight for Basel III, which represented the risk-weighted assets under Basel III for that category.

The "impact" of Basel III was the Basel III amount per category less the Basel I amount per category, per bank, which represented the increase in risk-weighted assets for that category. The impact amount from each category was added to the "base risk-weighted assets" calculated in step 1 per bank. The sum of the

base risk-weighted assets plus the impacts of each category represented the Basel III risk-weighted asset amount.

4. Additional Notes:

- This analysis was replicated for banks and bank holding companies.
- For the bank holding company analysis, used only top-tier BHCs with more than $500 million in total assets.
- Instances where tier 1, as reported in the Call Report or Y-9C was negative was left in the analysis, assuming that the reported figures were accurate.

TESTIMONY OF

GREG GONZALES

COMMISSIONER OF FINANCIAL INSTITUTIONS

TENNESSEE DEPARTMENT OF FINANCIAL INSTITUTIONS

On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

"EXAMINING THE IMPACT OF PROPOSED RULES TO IMPLEMENT BASEL III CAPITAL STANDARDS"

Before the

FINANCIAL INSTITUTIONS AND CONSUMER CREDIT SUBCOMMITTEE

INSURANCE, HOUSING, AND COMMUNITY OPPORTUNITY SUBCOMMITTEE

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

Thursday, November 29, 2012, 10:00 a.m.

Room 2128 Rayburn House Office Building

Introduction

Good morning, Chairman Capito, Chairman Biggert, Ranking Member Maloney, Ranking Member Gutierrez, and distinguished Members of the Subcommittees. My name is Greg Gonzales, and I serve as the Commissioner of Financial Institutions for the State of Tennessee. I am also the Chairman of the Conference of State Bank Supervisors (CSBS). It is my pleasure to testify before you today on behalf of CSBS.

CSBS is the nationwide organization of banking regulators from all 50 states, the District of Columbia, Guam, Puerto Rico, and the U.S. Virgin Islands. State banking regulators supervise, in cooperation with the Federal Deposit Insurance Corporation or the Federal Reserve, approximately 5,400 state-chartered insured depository institutions. Further, most state banking departments also regulate a variety of non-bank financial services providers, including mortgage lenders. For more than a century, CSBS has given state supervisors a national forum to coordinate supervision of their regulated entities and to develop regulatory policy. CSBS also provides training to state banking and financial regulators and represents its members before Congress and the federal financial regulatory agencies.

Today's hearing focuses on one of the most significant public policy matters facing the banking industry. The Basel III and Standardized Approach proposals would introduce sweeping changes to the regulatory capital framework and would significantly impact banks' credit allocation decisions and tolerance for risk. These proposals have emerged in a period when industry participants and policymakers alike are attempting to restore stability to the U.S. economic system and foster job growth. This also occurs at a time when many smaller institutions are expressing concern about regulatory burden and the impact regulation may be having on their long-term viability. As I will discuss more thoroughly, I believe it is in the best interest of the financial industry and the broader economy for the federal banking agencies to consider significant revisions to the proposals.

We appreciate the agencies' outreach to facilitate the industry's understanding of the capital proposals. They have gone to great lengths to deliver the facts of the proposals to the public. Their efforts have included hosting webinars, roundtables, and developing a calculator for banks to get a sense of their position within the context of the proposals. Indeed, I believe one of the main reasons for the volume of comment letters is due to their outreach. I have never seen a public policy matter to which the industry and other relevant stakeholders have been so well-informed and so well-versed. The educational aspect of the process has created a healthy and thorough dialogue on the proposals.

To be clear, we absolutely support enhancing the quality of capital and increasing required minimum capital. State bank regulators believe the agencies should pursue this effort outside of the Basel III process. But I also believe the issue at hand presents an opportunity for all of us to thoroughly evaluate our methods for developing meaningful and effective public policy to support our regulatory and economic goals. I am certain the lawmakers, federal regulators, and state bank regulators here today share the collective goal of supporting the effort to strengthen our financial system and generate stability for the American people. This is the fundamental concept that will frame my comments and suggestions.

Effective and Forward-looking Capital Regulation Requires a Balanced and Realistic Approach

The proposed capital rules are a symptom of a much bigger problem. Banking rules are increasingly being written with greater complexity and placing more burden on institutions. Federal policy, by its nature, tends to cover the entire industry with limited differentiation. The banking system is very diverse with over 7,200 banks ranging in size from a few million dollars in assets to well over one trillion dollars. Over 6,500 of these banks have assets under one billion dollars. Federal banking policy often applies to the whole industry, even if it is aimed at addressing issues particular to the largest, most complex institutions. As a result, these policies are increasingly inconsistent with how most banks conduct their business. Bankers are concerned they are losing their flexibility to exercise judgment which is critical to how a community bank functions. For most institutions, capital adequacy and risk management are not quantitatively or model driven. The management of risk for community banks is largely based on a thorough understanding of the underlying credit risk, a deep knowledge of its customer base, and an alignment between the success of the bank and its customers. State bank regulators fundamentally believe this is a model that must be maintained for our collective economic benefit.

We are concerned that regulatory policy is driving the industry to be too conservative. Leading up to the financial crisis, some institutions were over-extended in their risk tolerance in certain asset classes. This was matched by a regulatory environment which misjudged the bank's ability to manage risk and absorb losses. However, state bank regulators do not believe that the answer to every problem should be more capital. We must learn from these mistakes and expect more from banks in terms of risk management and improved supervisory processes. These are more difficult tasks, but I believe we have done this and can do more. The rules as proposed will do little more than limit credit to the most conservative exposures.

We need rules that ensure safety and soundness but permit banks to achieve economic success. It is important for us to remember that while 463 banks have failed in this cycle, over 7,000 banks survived. In addition, the resolution regime established by Congress and funded by the industry through the FDIC worked exactly as designed for all but our largest banks. The objective of our system-wide regulatory apparatus should not be to prevent all bank failures. Banks need to take prudent risks to serve their communities. When they make mistakes or when the economy moves against their exposures, we need to have confidence in a system that tailors a specific regulatory response according to the circumstances, while minimizing the economic and consumer impact. Banks must have the possibility of failure to have the opportunity for success.

The Proposed Rules Have Consequences for Economic Recovery and Job Growth

These proposals are fundamentally about economic development and job growth. Banks, all models and sizes, are a critical component of our economic engine. In particular, community banks are the primary drivers of local economic activity and small business job growth. CSBS is deeply concerned that the proposed capital framework will hamper banks' ability to take prudent risks in a period when general economic activity is minimal. In this sense, the proposals run counter to our efforts to restore the economy and foster job creation. We need

to seek policies that will encourage economic recovery in a prudent fashion, not policies that will further suppress the flow of credit or drive business from the regulated and insured depository system. Regulatory policy, both state and federal, has very local and very real economic consequences. When community banks are challenged, the communities they serve are challenged, as well.

We do not believe there is a sufficient understanding of the impact these proposals would have on the industry and credit availability. The agencies have published little analysis of the economic impact of these proposed rules, a step we believe is imperative before adopting such consequential measures. This lack of analysis bolsters uncertainty in the market and contributes to general business hesitancy. Four business days before the comment deadline for the proposals, the FDIC published for comment its statutorily mandated analysis of the impact the Standardized Approach proposal would have on banks with assets less than $175 million. The OCC and FRB have not yet published their analyses. The FDIC's conclusion, which finds that the Standardized Approach proposal will in fact have a significant economic impact on a large number of small entities, is troubling. It is important to note that this analysis was only performed for those institutions below $175 million in assets. The same type of analysis, if applied to the rest of the industry, may yield more striking results.[1]

Through the comment solicitation process, banks and other commenters have provided good examples of how the proposals will negatively impact traditional business lines that are fundamental to banks' operations and important to economic growth. We need to clearly understand how the proposals will change the type of credit available, the manner in which a bank lends, and the economic impact.

The Capital Rules Must be Part of a Targeted and Forward-Looking Regulatory Regime

Beyond the need to appropriately assess the proposals' impact on economic recovery and job growth, I strongly believe the proposals present an opportunity for us to critically evaluate our policy development approach. The industry has been very vocal about its concerns regarding regulatory burden. In our own experience, this is relatively easy to understand, but difficult to address. There is an opportunity for the industry and policymakers to discuss a prudent "right-sizing" of regulatory expectations. Furthermore, we can do much to address these concerns by carefully evaluating current proposals through the lens of regulatory burden and the appropriateness of regulation for the wide variety of institutions that operate within the U.S. The Basel III and Standardized Approach proposals are perfect examples of policy matters that we need to get correct immediately. We must take a long-term view of the industry and offer appropriate flexibility to accommodate the diversity of our financial system and the dynamic nature of the U.S. economy.

There are legitimate concerns about the complexity of the proposals, especially the Standardized Approach. I fully recognize that particular aspects of today's financial services industry present complex issues which must be addressed. However, not all transactions are complex and need a complex solution. Most of traditional banking follows the fundamentals: character, repayment ability, and collateral protection. If we want to effectuate change, it should

[1] Exhibit A: CSBS comment letter on FDIC's Regulatory Flexibility Analysis for the Standardized Approach Proposal

be focused on risk management and consistent with how the bank operates. Complexity that serves to discourage certain types of lending leads to credit allocation, which will increase the cost of credit for consumers and drive industry consolidation.

State bank regulators believe the Basel III and Standardized Approach proposals are highly reactionary to the latest crisis. We do not believe a capital regime that is reacting on a transaction-by-transaction basis to crises is good public policy or in the long-term interest of the banking system. To illustrate my point, I'll reference my counterpart from Oklahoma's comment letter on the proposals. In the letter, Oklahoma Commissioner Mick Thompson points out that the mortgage issues which underlie the financial crisis never existed in Oklahoma, but the proposed risk weights for mortgage loans in the Standardized Approach proposal will have a significant impact on banks' ability to lend. This not only affects the banks in Oklahoma, but has a direct effect on the availability and cost of credit for the citizens of Oklahoma.

Because of the remarkable diversity in the U.S. economy and in the banking industry, it is important that we focus on improving risk management and supervision, not on trying to steer individual credit decisions. This is the most logical method for addressing the types of issues that are the focus of the Basel III and Standardized Approach proposals. Simply adjusting the capital rules in response to every financial issue is not the answer. Once we head down this path, it is difficult to imagine where we will stop.

Regulation Should Address "Too Big to Fail" in a Targeted Manner

One of the primary points made by the supporters of Basel III is the need to address the weaknesses of systemic institutions. CSBS would support any rulemaking the agencies pursue to address these issues, if they are applied to the largest internationally active banks, as intended by the international accord. The Dodd-Frank Act also requires a range of measures geared toward subjecting Systemically Important Financial Institutions (SIFIs) to stricter standards, including: enhanced prudential standards; living wills; Orderly Liquidation Authority; stress testing; concentration limits; and designations. We support the efforts of the federal agencies to finalize and enforce these provisions as they are our best hope to address the problem of "too big to fail."

CSBS Positions in Brief

The federal banking agencies' rulemaking comprised three proposals to revise the U.S. regulatory capital framework. These were the Basel III, the Standardized Approach for Risk-Weighted Assets, and the Advanced Approaches proposals. I will focus my comments on the Basel III and Standardized Approach proposals, which apply to the entire commercial banking industry.

The Basel III proposal revises minimum regulatory capital levels, introduces a new common equity ratio, makes changes to the definitions of capital, re-works the Prompt Corrective Action (PCA) framework, and creates new standards in the area of Trust-Preferred Securities (TruPS). The Standardized Approach for Risk-Weighted Assets proposal outlines a radically new structure for risk-weighting assets used to calculate risk-based capital ratios. The

new risk weights will affect asset classes such as residential mortgages, certain commercial real estate loans, off-balance sheet exposures, securitizations, and equity exposures, among others.

I believe it is critical to understand the intended scope of Basel III and the actual scope of the framework the agencies have proposed. The Basel III Accord clearly states that it is intended to apply to those institutions addressed in Basel II. Basel II addresses large, internationally active banks. Basel III was never intended to apply to the entire banking industry. The framework the agencies have proposed therefore goes beyond the scope of the international agreement. It is important to further clarify that the Standardized Approach proposal is not included in the Basel III agreement. State bank regulators believe the agencies should re-evaluate the content of the proposals as a whole and re-propose Basel III to apply only to those institutions to which it was originally intended to apply. If there is a desire to raise required minimum capital for all banks, this should be pursued outside of the Basel III implementation process. The agencies have authority to establish minimum required capital. Any necessary adjustment to the minimum required capital should be proposed and justified in terms of the needs and risks of domestic institutions.

In general, the proposals are highly reactionary to the most recent crisis and attempt to remedy the various issues of the financial crisis on a transaction-by-transaction level. My fellow state bank regulators and I believe this approach is likely to yield a capital framework that is far more prone to volatility. In our estimation, regulators and policymakers do not have to address all financial vulnerabilities and risks identified during the financial crisis through capital standards. I strongly believe we should strive to address appropriate issues through risk management and the supervisory process. Additionally, state bank regulators believe the agencies have an obligation to provide empirical support for their recommended course of action, especially related to the risk-weighting figures. In many cases, there does not seem to be adequate logic to support many of the proposed risk weights. Further, as I will address in my analysis of the proposals, the agencies' proposed rules will present significant challenges for key lending markets, particularly mortgage lending.

To address the substance of the proposals more specifically, state bank regulators find the complexity of the Basel III proposal problematic and strongly oppose the proposed inclusion of gains and losses on Available for Sale (AFS) securities in capital and the proposed phase out of TruPS. Within the context of the Standardized Approach proposal, we are troubled by the proposed risk-weighting scheme for residential mortgages, High Volatility Commercial Real Estate (HVCRE), and past-due exposures. Additionally, we believe further clarity is needed surrounding the proposed treatment of securitizations and equity exposures.

The Basel III Proposal

Shifting to the specific aspects of the proposals, I reiterate that state bank regulators support efforts to improve the quantity and quality of capital in the banking system. The crisis clearly demonstrated that capital levels at many institutions, although above minimum capital ratios for regulatory purposes, were inadequate to support the risk being assumed. However, there is a balance to be struck to promote a stable banking system, which is also attractive to capital. While we do not believe the proposed minimum capital levels contained in the Basel III

proposal are unreasonable, we do believe the proposed Basel III framework is too complex. The proposal would result in too many consequential ratios and benchmarks to which institutions would have to manage. For instance, the proposed capital conservation buffer, the level of which is not necessarily problematic, becomes operationally burdensome for institutions when compared to the proposed PCA framework, which does not factor in the buffer. Situations are likely to emerge where institutions will be "well-capitalized" for PCA purposes, yet will face mandatory dividend and bonus restrictions because they are under the total capital figure that combines the minimum ratio and the conservation buffer. Such operational complexity will present tremendously awkward and confusing positions for institutions, especially those that do not have sophisticated compliance functions.

Beyond the complexity associated with the capital levels, we are very concerned about the proposed incorporation of unrealized gains and losses on AFS securities in the Common Equity ratio. This provision is not workable or meaningful for the majority of banking institutions and will skew capital ratios, generating more volatility in an institution's capital position.

We also strongly oppose the agencies' proposed treatment of TruPS in the Basel III proposal. We believe this issue was thoroughly debated in Congress. The Dodd-Frank Act established a reasonable transition period for institutions. Currently, institutions with assets below $15 billion are allowed to let TruPS roll off. The agencies have proposed a phase out schedule for these institutions beginning in 2013 and increasing 10% every year thereafter. No TruPS would qualify as capital in 2022. This provision will be detrimental for institutions that have based their long-term capital planning process on the standards established by Dodd-Frank, adding an additional layer of uncertainty for institutions' business planning.

As detailed in our Basel III comment letter,[2] CSBS encourages the agencies to revise and re-propose Basel III to focus on the institutions intended by the international agreement—large, internationally active banks. There may be reason to review and revise the general domestic capital structure but not under the Basel III umbrella, and not in the manner in which this proposal is fashioned.

The Standardized Approach Proposal

The Standardized Approach proposal is highly reactionary to the most recent crisis, does not include empirical support for the proposed risk-weightings, and, if adopted as proposed, likely will not serve our long-term economic interest. As detailed further in our comment letter,[3] the agencies have not demonstrated in the proposal an adequate understanding of the impact these adjustments would have on credit allocation and availability.

Further, when comparing the relative risk-weightings under the proposed framework across asset classes, we run into a series of internal inconsistencies. As an example, unsecured lending under the proposed rule receives a 100% risk-weighting, whereas many forms of lending backed by collateral receive well above a 100% risk-weighting. This notion defies basic banking

[2] Exhibit B: CSBS Comment Letter on Basel III NPR
[3] Exhibit C: CSBS Comment Letter on Standardized Approach for Risk-Weighted Assets

principles. Regulators and bankers generally believe that collateral is better than no collateral. The rule seems to encourage otherwise. Possibly more striking is the risk-weightings for various forms of sovereign debt compared to Acquisition, Development & Construction (ADC) loans. Sovereign debt in default receives a 150% risk-weighting under the proposed rule; the same as so-called HVCRE loans. Sovereign debt that is not in default is graded against the OECD Country Risk Classification Index. Countries like Greece, Spain, and Italy all receive excellent scores on this index, which pushes their sovereign debt risk-weighting down well below 150%. By rule, we are effectively telling our banks to invest in the struggling Eurozone long before they consider investing in the construction project down the street. In practice, I do not believe most institutions would make this choice. However, I offer this comparison as an example of the unsupported logic of some of the risk weights.

On a specific level, I am extremely concerned by the proposed treatment of residential mortgage assets in the Standardized Approach proposal. Traditionally, mortgage loans have received a 50% risk-weighting under the agencies' general risk-based capital standards. In the Standardized Approach framework, the agencies have proposed to divide an institution's mortgage loans in two categories. The criteria for achieving Category 1 status is excessively narrow, excluding traditional products that banks have originated successfully for years. Such products include standard Adjustable-Rate and balloon mortgages, Home Equity Lines of Credit (HELOCs), and second liens. The agencies have erroneously painted these products with a broad brush. These were not the products that caused the mortgage crisis and were rarely used improperly by banks. Mortgage products that do not fall in Category 1 are pushed to Category 2, where the risk-weighting is remarkably punitive, ranging from 100-200% based on origination Loan-to-Value.

This dramatic shift in treatment of mortgage assets under the risk-based capital standards would have a significantly negative effect on banks' willingness and ability to engage in mortgage lending. It is easy to assume that the mortgage securitization market encompasses the entire mortgage lending industry. But this is simply not the case. Two and a half trillion dollars in residential mortgage exposure currently resides on banks' balance sheets. Banks dedicate approximately 20% of their lending portfolios to mortgages, a figure which is consistent across the industry.[4] This is not an insignificant exposure. A reduction in mortgage lending at banking organizations will work to the detriment of mortgage credit availability, especially in rural and underserved areas. It will also take away a key source of income from banks, thereby threatening profitability and safety and soundness. It is important to note that second lien HELOCs are frequently used by homeowners to finance small businesses. The impact of the mortgage provisions therefore extend to other critical aspects of the economy.

Another concerning aspect of the Standardized Approach is the proposal's treatment of HVCRE loans. This new designation encompasses ADC loans, with some exceptions related to borrower contributions and loans financing 1-4 family residential properties. The current risk-weighting for such loans is 100%. The proposed risk-weighting is 150%. Through the risk-weighting adjustment, the agencies have essentially signaled that they do not want banks to make these types of loans. This transaction-level risk-weighting does not account for concentration risk-management and institutional expertise. ADC loans have certainly played a major role in

[4] Exhibit D: Bank balance sheet exposures to real estate related loans

many of the bank failures that have occurred over the past few years. However, the proposed treatment of HVCRE loans is a perfect example of the misuse of risk-weightings on a transactional level. Increasing risk-weightings is not the answer for every risky asset exposure. We must focus on improving risk management and supervision surrounding problematic asset concentrations. This is the most effective way to build a strong, forward-looking regulatory framework, while avoiding a "one-size-fits-all" approach.

Detailed further in our Standardized Approach comment letter are suggestions surrounding the proposed framework for off-balance sheet exposures, securitizations, and equity exposures. Generally we believe further clarity is needed in these areas for specific purposes. I will focus my remaining Standardized Approach comments on the treatment of past-due exposures in the proposal. The proposal stipulates that once a loan becomes past due, its risk weighting jumps to 150%. Here we see another provision that will introduce more volatility to the capital framework. Additionally, the proposed treatment of past-due exposures creates a "double counting" problem. Allocations for past-due loans are generally made to loan-loss reserves, thereby lowering an institution's capital level. Considering the proposed treatment of such exposures, an institution would also have to increase its risk-weighted assets in the event of a past-due loan. The effect of this, when considering regulatory capital ratios, is an increasing denominator and a decreasing numerator. The negative effect of a past-due loan is thus compounded significantly within the context of the proposal. We are also concerned that this provision of the capital rule will impact a bank's ability to prudently and effectively manage credit administration by incentivizing credit extensions. This practice can be considered unsafe and unsound.

The Standardized Approach proposal has the potential to significantly alter banks' credit decisions to the detriment of the economy. This proposal, which is not part of the Basel III Capital Accord, should be significantly revised or altogether abandoned.

A Local Perspective

It is important to remember that many institutions do not treat loans as anonymous commodities and that these proposed rules will have real consequences for institutions and communities. Here is one example. There is a small bank that is the only bank in a very rural community in Middle Tennessee. This bank has been around for almost 100 years and has a customer base that it has been serving for decades with products including mortgages that the bank holds in portfolio. The president of that bank shared with me that, based on his review of the proposed rules, when those same customers come seeking new loans, the proposed risk weights for mortgages will limit the number and volume of loans it can originate. The overwhelming community bank engagement on this topic is a testament to their passion and conviction regarding the critical role they play in our economy. We owe it to these institutions to ensure the policies we develop do not unnecessarily impede their ability to serve their communities.

There are matters within the context of the community banking business model that the industry is best equipped to address, particularly those dealing with human capital, corporate governance, succession planning, and risk management. Further, more pertinent to our world, there are adjustments we need to make to the supervisory process to facilitate progress in this

area. Specifically, we need to encourage a supervisory process that minimizes burden and disruption, provides value, and gets away from the penalty mindset and returns to a corrective, cooperative relationship. All this said, community banks will not survive if public policies irresponsibly drown them out.

Conclusion

The debate over these proposals, with meaningful and significant engagement from the industry and Congress, provides an opportunity for us to determine the appropriate approach to policy development for a diverse economy and a diverse financial system. We have an opportunity to signal to the industry and to the rest of the economy that we are committed on a going forward basis to meaningful public policy development geared toward fostering economic recovery and job growth. Further, these proposals are relevant to the debate surrounding the viability of the community banking business model. This is of deep importance to me and my colleagues from around the country. This is also important to our citizens who do not all live in large metropolitan areas or have access to the services of our largest institutions. Community banks are the lifeblood of the American economy and will be a key player in the economic recovery. Our economy is built on diversity and locality; community banking has been the backbone of this success. I strongly believe that we need to explore a regulatory framework comprising prudent and meaningful rules for community banks.

The Basel III and Standardized Approach proposals are perfect examples of policy concepts that need to be re-evaluated, better understood, and appropriately calibrated for our diverse banking system. State bank regulators have urged the agencies to significantly revise the proposed structure, so we have a regulatory capital framework that is meaningful for community banks and consistent with the practices of the business model.

CSBS stands ready to work with Members of Congress and our federal counterparts in seeking the appropriate regulatory balance and pursuing our collective goal of restoring stability to the American economy.

Thank you for the opportunity to testify today, and I look forward to answering any questions you have.

Exhibits

Exhibit A: CSBS Comment Letter on FDIC Initial Regulatory Flexibility Act Analysis

Exhibit B: CSBS Comment Letter on Basel III Proposal

Exhibit C: CSBS Comment Letter on Standardized Approach Proposal

Exhibit D: Data on Bank Real Estate Exposures

Exhibit A



CONFERENCE OF STATE BANK SUPERVISORS

November 14, 2012

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
RIN 3064-AD96

Dear Mr. Feldman,

The Conference of State Bank Supervisors (CSBS) is pleased to comment on the Federal Deposit Insurance Corporation's (FDIC's) Initial Regulatory Flexibility Analysis (IRFA) for its Notice of Proposed Rulemaking (NPR) entitled *Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements* (Standardized Approach proposal).

Section 3(a) of the Regulatory Flexibility Act (RFA) requires an agency to publish in the Federal Register an IRFA or a summary of its IRFA, or to certify that the proposed rule will not have a significant economic impact on a substantial number of small entities. For purposes of the IRFA, a small entity includes a banking organization with total assets of $175 million or less.

The FDIC published this IRFA addressing the Standardized Approach Proposal on October 17, 2012 separately from the Federal Reserve Board (FRB) and the Office of the Comptroller of the Currency (OCC), the two agencies with which the FDIC published the proposed rule.

FDIC CONCLUSIONS

As detailed in the IRFA, to determine if the Standardized Approach proposal would have a significant economic impact on small banks and savings associations, the FDIC compared the estimated annual cost with annual noninterest expense and annual salaries and employee benefits for each institution. If the estimated annual cost was greater than or equal to 2.5 percent of total noninterest expense or 5 percent of annual salaries and employee benefits, the FDIC classified the impact as significant. The FDIC has concluded that the proposals included in the NPR would exceed this threshold for 2,413 small state nonmember banks, 114 small savings banks, and 45 small state savings institutions. Accordingly, for the purposes of this IRFA, the FDIC has concluded that the changes proposed in the Standardized Approach NPR, when considered without regard to other changes to the capital requirements that the agencies simultaneously are proposing, would have a significant economic impact on a substantial number of small banks and savings associations. Further, if both the Standardized Approach NPR and the Basel III NPR were adopted together, the impact on small institutions would increase.

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Exhibit A

ECONOMIC IMPACT

In our comments to the agencies on the Basel III and Standardized Approach proposed rules, we highlighted the potentially negative impact the proposals could have on the economy and on job growth. It seems the analysis conducted in the FDIC's IRFA supports our projections. The FDIC has estimated that the Standardized Approach proposal will have a significant impact on 2,413 institutions with assets below $175 million that are under the agency's regulatory purview. This is clearly a significant number of institutions. It is important to note that this analysis was only performed for those institutions below $175 million in assets. The same type of analysis, if applied to the rest of the industry, may yield more striking results.

As detailed in our comment letters, we support the effort to quantify the impact these proposals could have on the industry. We therefore endorse the FDIC's work in this area, and we believe the FDIC employed a thoughtful and sound methodology to evaluate the potential impact on small institutions. Given the fact that this analysis has yielded a positive affirmation that the proposals would have a significant economic impact on at least those institutions below the RFA threshold, we strongly urge the FDIC and the other agencies to consider measures that may be taken to lessen the potentially negative impact their proposals may have on the general economy and on job growth.

INCONSISTENCY IN EVALUATION

CSBS would like to note the inconsistent fashion in which the agencies have performed their required IRFAs on the Basel III and Standardized Approach proposals. We understand the agencies' obligation is to focus on the institutions they individually regulate. However, we find it troubling that the agencies seem not to have worked closely on these analyses and did not develop a common understanding of the proposals' potential impact. All the agencies performed an IRFA on the Basel III proposal and published some preliminary economic impact dialogue in the Standardized Approach proposal. The methodologies the agencies have used to evaluate the proposals' impact are different, and the conclusions are not consistent.

We believe it is important for the agencies to establish a unified understanding of the potential economic impact the Basel III and Standardized Approach proposals would have on the industry before releasing proposals of this magnitude. We note that the FDIC's supplemental analysis was released only four business days before the end of the comment period for the proposal in question. The FRB and OCC still have not released their own supplemental analyses referenced in the FDIC's notice. The FDIC maintains that any comments on this notice will be considered in the development of a final rule. However, we believe the utility of the IRFA is significantly minimized since the public was not able to supplement its analysis of the proposals themselves with the agencies' projections.

Overall, we are concerned that the inconsistent approach employed by the agencies to evaluate the impact of the proposals, combined with the actual conclusion of the analysis, which is not encouraging, contribute to the uncertainty surrounding the proposals and the need to re-evaluate their structure.

Sincerely,



John W. Ryan
President and CEO

Exhibit B



CONFERENCE OF STATE BANK SUPERVISORS

October 17, 2012

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
RIN 3064-AD95

Office of the Comptroller of the Currency
250 E Street, SW, Mail Stop 2-3
Washington DC, 20219
Docket ID OCC-2012-0008

Jennifer J. Johnson
Secretary, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1430;
RIN No. 7100-AD87

Dear Sir or Madam,

The Conference of State Bank Supervisors (CSBS) appreciates the opportunity to comment on the Federal Deposit Insurance Corporation's (FDIC's), the Board of Governors of the Federal Reserve System's (FRB's), and the Office of the Comptroller of the Currency's (OCC's) (collectively, "the Agencies") joint Notice of Proposed Rulemaking (NPR, proposal, or proposed rule) to implement the Basel III capital accords, entitled *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action.*

In our view, the proposed rule is one of the most significant public policy matters facing the financial sector. The appropriate level of capital should enhance the resiliency of the banking sector, allowing institutions to remain solvent through the economic cycle. However, too much capital can have undesirable effects on the industry. Too much capital can have the effect of increasing management's tolerance for risk as they strive to provide a return for stockholders. An overly restrictive capital requirement also serves as a barrier to entry, discouraging capital from entering the banking system and further driving industry consolidation. It is critical to strike the appropriate balance to achieve a stable banking system, which is attractive to capital, and can serve as the backbone to a vibrant and diverse economy. This comment period provides a critical opportunity for the public to express its views on the proposed rules and the potential impact they will have on banks, credit availability, and economic growth. We encourage the Agencies to consider not only the calibration of capital requirements to ensure a resilient banking system, but also what is in the best interest of both the national and local

economies. Capital requirements must factor in the existence of an active supervisory function and a resolution regime, which works as designed for the vast majority of banks.

We have provided feedback on the Agencies' Standardized Approach proposed rule in a separate comment letter. Our comments on the Basel III proposed rule are organized in the sections below.

INTRODUCTION

We support the Agencies' efforts to increase the minimum required capital. However, we are concerned with the ability to achieve this under the Basel III umbrella. The international agreement clearly states it is intended to cover the same institutions covered under Basel II,[1] which targets only large, internationally active banks. The agreement was never intended to apply to all U.S. banks. We recommend the Agencies scale back this rulemaking to apply only to the intended institutions. We would support a separate rulemaking to address the minimum capital requirements for banks not covered by Basel II and Basel III. The proposed rule should be appropriately calibrated to enhance stability while serving to attract capital to the system. The proposed rule must be easy to understand and simple to manage. We believe the public comments to this rulemaking will provide the Agencies sufficient feedback to effectively structure a new proposal.

MINIMUM CAPITAL RATIOS

CSBS generally supports a higher level of high quality capital at banking organizations. The financial crisis clearly demonstrated that capital levels meeting minimum capital requirements for regulatory purposes are not adequate for practical purposes during stressful conditions. Considering the experience of the US financial crisis, the Agencies have proposed to introduce higher minimum capital requirements for banking organizations.

Specifically, the Agencies have proposed to eliminate the exception for CAMELS 1 rated institutions to maintain a Tier 1 Leverage Ratio of 3%. All institutions will now have to adhere to a Tier 1 Leverage Ratio of 4%. CSBS supports a higher minimum Tier 1 Leverage Ratio. Practically, 4% is not an adequate level of operating capital for all institutions. We support the Agencies' comments regarding the need for institutions to hold capital commensurate with the risks and complexity of their business activity, regardless of the regulatory capital ratios.

Additionally, the Agencies have proposed a new Tier 1 Common Equity Capital ratio. Institutions would have to maintain a minimum Tier 1 Common Equity ratio of 4.5% to meet minimum capital requirements. CSBS supports a renewed focus on common equity, as this is the strongest form of capital. Community banks typically hold a higher percentage of common equity than larger institutions. A new common equity ratio should contribute to a more level playing field between community banks and large banks. As discussed further below, we do not support the proposal to include unrealized gains and losses on available for sale securities

[1] Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010, page 11.

in the definition of Tier 1 Common Equity. Nevertheless, we generally support the common equity ratio and believe it will enhance the quality of capital positions across the industry.

For Tier 1 Risk-Based Capital, the Agencies have proposed to increase the minimum ratio from 4% to 6%. We support the increase in Tier 1 Risk-Based Capital. The Agencies have not proposed to adjust the current Total Risk-Based Capital Ratio of 8%.

CAPITAL CONSERVATION BUFFER

The Agencies have proposed that institutions hold a capital conservation buffer comprising common equity tier 1 capital. The buffer represents an additional 2.5% of total risk-weighted assets. The buffer must be maintained to avoid restrictions on capital distributions and certain discretionary bonus payments. This has the effect of increasing the minimum risk based capital ratios by 250 basis points.

While we support requiring greater amounts of high quality capital, to the extent the capital conservation buffer introduces undue operational complexity for institutions, we believe regulators should work to clarify expectations. As discussed further in the Prompt Corrective Action (PCA) section of this letter, the number of consequential capital ratios detailed in the proposal to which institutions would have to adhere would introduce undue complexity to the capital planning process for banking organizations.

COUNTERCYCLICAL CAPITAL BUFFER AND SUPPLEMENTAL RATIO

The Agencies have proposed to implement the Basel III countercyclical capital buffer for advanced approaches institutions, which generally includes institutions with assets above $250 billion. The countercyclical capital buffer would be based on detailed market indicators and would require larger institutions to hold up to 2.5% of additional risk-based capital. CSBS supports the Agencies' proposal to apply the countercyclical capital buffer only to institutions with assets above $250 billion. Larger institutions have greater access to capital markets, which will allow them to more reasonably meet the requirements of the countercyclical buffer. We also support the theoretical structure of the countercyclical capital buffer as it applies to advanced approaches institutions.

Additionally, advanced approaches institutions would be required to maintain a supplementary leverage ratio of tier 1 capital to total leverage exposure of 3%. We support the supplementary leverage provision. However, the off-balance sheet exposures and repo style transactions the Agencies site in support of this requirement occur frequently at large institutions that do not meet the advanced approaches criteria. The Agencies may consider application of the supplementary leverage ratio to classes of institutions with assets below $250 billion but not less than $50 billion on a case by case basis.

PROMPT CORRECTIVE ACTION

The Agencies have proposed a method for incorporating changes to minimum capital ratios in the Prompt Corrective Action (PCA) framework. The proposed PCA framework includes new

ratios corresponding to the various capitalization designations contained in PCA. Notably, the proposal does not factor the capital conservation buffer in the PCA ratios.

In our view, under the current proposal, institutions will have to manage their capital levels with too many consequential measures in mind. The proposals include new minimum capital requirements, new additional capital requirements for capital conservation buffer purposes, and new PCA requirements. The Agencies should work to streamline the PCA requirements to acknowledge the presence of the capital conservation buffer and clarify the implications associated with the various thresholds. We should work to minimize the operational complexity at institutions that can arise from numerous regulatory capital measures.

The currently proposed framework presents an awkward situation for institutions. For instance, the proposed measure of total risk-based capital to be considered "well-capitalized" for PCA purposes is 10%, yet the minimum total risk-based capital ratio including the 2.5% capital conservation buffer is 10.5%. Therefore, institutions may be "well-capitalized" but still have mandatory restrictions on dividend and bonus payouts. We encourage the Agencies to acknowledge and resolve such discrepancies that may result in confusion for bank management.

UNREALIZED GAINS AND LOSSES ON SECURITIES IN COMMON EQUITY TIER 1 CAPITAL

Under the Agencies' current general risk-based capital rules, unrealized gains and losses on Available For Sale (AFS) debt securities are not included in regulatory capital, unrealized losses on AFS equity securities are include in tier 1 capital, and unrealized gains on AFS equity securities are partially included in tier 2 capital. Under the proposal, unrealized gains and losses on all AFS securities would flow through to common equity tier 1 capital.

CSBS does not believe this provision is workable or meaningful for banking organizations. Including gains and losses on AFS securities in the common equity ratio would introduce significant volatility in capital ratios and potentially skew institutions' capital positions both in times of crisis and in periods of stability. The frequency and extent to which the proposed provision would adjust capital positions would be substantial. We believe capital measurements that are built on potentially significant volatility are not meaningful and may have detrimental consequences for the safety and soundness of our banking industry. We are concerned that this provision may cause banks to engage in transactions that they otherwise would not out of fear of the impact of potential future losses from changing market conditions. Incorporating this element of volatility into the capital framework is not in the long-term best interest of individual banks or the banking system.

The proposal offers possible alternatives, including excluding the impact solely from changes in interest rates and excluding U.S. government and agency securities. Firms that provide investment advisory services to the industry believe this will be nearly impossible to accurately quantify on a consistent basis. The Agencies should adequately research this perspective before finalizing any rule to ensure the option is workable and meaningful. To be clear, we believe the existing framework is more applicable to a traditional bank and provides for less complexity and greater stability.

Exhibit B

TRUST PREFERRED SECURITIES

Basel III eliminates Trust Preferred Securities (TPS) as qualifying capital for all banks and bank holding companies above $500 million in assets. For bank holding companies with assets above $15 billion, the Basel III proposal maintains consistency with Dodd-Frank, retaining a phase-out period ending in 2016. For bank holding companies with assets between $500 million and $15 billion, the Agencies have proposed a phase-out schedule beginning at 10% in 2013 and increasing 10% a year for 10 years. No TPS would count beginning in 2022. The proposed treatment of TPS deviates from Dodd-Frank, which allows bank holding companies between $500 million and $15 billion to let the TPS roll-off.

CSBS strongly opposes the Agencies' proposed treatment of TPS for institutions between $500 million and $15 billion. The proposed rule represents a new and unnecessary extreme in the area of TPS. We are troubled by the Agencies' inclination to deviate from the Dodd-Frank standard. Implementing a sudden shift in policy related to TPS may have significantly negative consequences for institutions' capital planning strategies. Further, CSBS believes this matter was thoroughly reviewed in Congress during Dodd-Frank deliberations, and Congress elected to establish the framework detailed above for good reason. We therefore urge the Agencies to withdraw their proposed phase-out of TPS for institutions between $500 million and $15 billion and maintain the framework established by Congress.

CAPITAL TRANSITION PROVISIONS AND INFORMATION GAPS

CSBS generally believes the Agencies have proposed reasonable transition provisions for institutional compliance with the proposed capital requirements if the requirements are imposed.

We would also like to note that a number of information gaps exist in current financial reporting requirements that will make it difficult to assess the potential impact of various provisions of the proposal. Specifically, financial positions such as Deferred Tax Assets (DTAs) are not reflected in current regulatory reports in adequate detail, yet there are a number of proposed provisions affecting these assets. In order to adequately measure the impact of such requirements, we need to address reporting gaps in these areas.

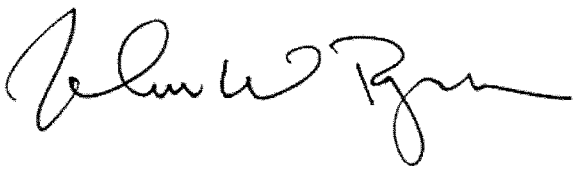
Exhibit B

CONCLUSION

We are supportive of the Agencies' efforts to improve the level and quality of minimum required capital. We strongly recommend the Agencies pursue a more simplistic and effective proposal appropriate for a diverse banking system which is largely dominated by less complex, community based institutions.

As the Agencies consider a revised and narrower proposal, it is important to be able to quantify the impact on the industry. We appreciate the Agencies' efforts to develop the capital estimation tool for banks to analyze the potential impact of this rule and the proposed rule for the Standardized Approach. We believe it is imperative for the Agencies to understand the impact on an aggregate basis and, more importantly, have a better sense of how changes in the capital rules will impact the bank's origination of credit.

Best regards,



John W. Ryan
President & CEO

Exhibit C



CONFERENCE OF STATE BANK SUPERVISORS

October 17, 2012

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
RIN 3064-AD96

Office of the Comptroller of the Currency
250 E Street, SW, Mail Stop 2-3
Washington DC, 20219
Docket ID OCC-2012-0009

Jennifer J. Johnson
Secretary, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1442;
RIN No. 7100-AD87

Dear Sir or Madam,

The Conference of State Bank Supervisors (CSBS) appreciates the opportunity to comment on the Federal Deposit Insurance Corporation's (FDIC's), the Board of Governors of the Federal Reserve System's (FRB's), and the Office of the Comptroller of the Currency's (OCC's) (collectively, "the Agencies") joint Notice of Proposed Rulemaking (NPR, proposal, or proposed rule) to adjust the Agencies' general risk-based capital requirements for determining risk-weighted assets, entitled *Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements.*

CSBS supports the Agencies' efforts to improve capital standards for the US banking system. We hope the Agencies will work to establish standards that are in the best interest of all financial institutions and the larger US economy. We have provided feedback on the Agencies' Basel III proposed rule in a separate comment letter. Our comments on the Standardized Approach proposed rule are organized in the sections below.

SUMMARY OF CSBS POSITION

CSBS is opposed to the proposed rule to revise the risk weights for risk-based capital. We come to this very clear position after extensive study of the proposal and dialogue with state supervisors. This position is based on the following concerns and beliefs:

1. The proposed rule is reactionary to the most recent crisis with a focus on housing and commercial real estate.

2. The approach proposed by the Agencies will curtail bank lending in traditional mortgage products that they have generally managed well.
3. There is no empirical support for the proposed risk weights.
4. As we seek to address concerns that emerged from the financial crisis, greater appreciation must be paid to risk management and the supervisory process to address evolving risk concentrations rather than capital weightings of broad asset types based solely on imperfect correlations perceived from the last crisis.
5. The proposed framework is overly complex.
6. There is not sufficient understanding of the impact of the proposed rule on the industry, the potential change in business practices, and the impact on credit availability.

The approach taken by the Agencies is targeted at the major risk drivers for problem banks during this crisis. However, while over 450 institutions failed from 2008 through the present, we must remember that the majority of institutions did not fail. In fact, out of the nearly 2,300 banks with concentrations in commercial real estate loans in 2007, over 1,200 maintained a low level of problem assets and are profitable today.

As we seek to improve the quality and quantity of capital, we believe it is important to resist the temptation to address every financial weakness through capital. We must seek to apply lessons learned to improving risk management and the supervision process. If not, we will continuously seek to make the industry more risk averse, which will curtail access to credit and harm economic growth.

CSBS has supported prior agency efforts to enhance the risk sensitivity of the capital rules. We commented in January 2006:

> "a successful domestic capital framework will not only benefit individual financial institutions which effectively utilize risk management tools, but will also benefit the banking system as a whole by providing greater ability to effectively and efficiently manage capital."

The challenge before the Agencies is to do this while not adding complexity. We do not believe the rule as proposed meets these objectives. The proposed rule is not balanced in its treatment of exposures and will present undue complexity for the industry. Unfortunately, we must recognize that risk-based capital has limited utility for bank management. Bankers have clearly communicated to state commissioners that they view this as a regulatory exercise, not a tool for risk management. We must question the value of a proposed regulation which provides little or no value to the industry. As state and federal supervisors find value in the framework, we believe it would be worthwhile to enhance our collective understanding on a framework which would prove valuable for the industry and the regulators.

In order to truly improve the risk sensitivity of the capital rules, the categorization of exposures and risk weights need to be supported. The categorization of assets should be aligned with the variety of practices of banks for the origination of credit, while accepting that banks have

different levels and areas of expertise and appetite for risk. The assigned risk weights must have a reasonable correlation with the risk and not be used as a tool for the allocation of credit and the creation of an overall more conservative industry.

In the implementation of Basel II, the Agencies went through a series of "Quantitative Impact Studies." This was important to understand the impact on banks and the ability to conform to the framework. From this, public policy makers and observers were able to judge and opine on the readiness of institutions, the impact on the banks, and the potential changes to the credit markets and availability. While a comprehensive impact study would create its own burdens, the system and the economy are ill-served by not having a better understanding of the desirable and undesirable ramifications of changing the risk weights in the manner proposed. Based on industry reactions, the proposal will clearly have a negative impact on credit allocation. Policy makers have a responsibility to understand these changes and evaluate the potential impact on the banking system and economy.

RESIDENTIAL MORTGAGE EXPOSURES

Current risk-based capital requirements generally prescribe a 50% risk-weighting for residential mortgage exposures. The proposed rule introduces a complex scheme for risk-weighting residential mortgage exposures. This process divides residential mortgage exposures into two categories: Category 1 and Category 2. The Agencies have proposed a detailed set of standards that mortgages must meet in order to achieve Category 1 status. Among other criteria, Category 1 mortgages must be fully amortizing, without a balloon payment, and meet strict underwriting criteria. Any mortgage that does not meet the Category 1 criteria would be deemed a Category 2 mortgage.

Once a mortgage is categorized, its risk-weighting would be assigned based on the Loan-to-Value (LTV) ratio of the loan within the eligible risk-weighting range of the category. Category 1 mortgages would be assigned a risk-weighting between 35% and 100% based on LTV. Category 2 mortgages would be assigned a risk-weighting between 100% and 200% based on LTV.

CSBS believes the proposed treatment of residential mortgage exposures will have a detrimental effect on access to mortgage credit. We strongly oppose the proposed scheme for risk-weighting residential mortgage exposures, and we urge the Agencies to re-work or abandon the proposed approach. Chief among our concerns is the excessively narrow criteria for Category 1 mortgages. In our estimation, traditional products such as adjustable-rate mortgages (ARMs) and other products with balloon features would not qualify as Category 1, subjecting them to the Category 2 risk weights. Many banks also offer second lien and Home Equity Lines of Credit (HELOCs). This is an important source of credit for consumers and small businesses. These loans would also be designated as Category 2. The highly punitive risk-weightings for all mortgages in Category 2 would effectively discourage institutions from engaging in such transactions. Thus, designation of these transactions as Category 2 loans will largely eliminate an important source of credit for consumers and small businesses and a reliable business line for the institutions, thereby restricting access to credit and negatively impacting the safety and soundness of banking institutions, and the overall economy.

We are concerned that the rule unnecessarily paints these products with a very broad brush. This could have an impact on the availability of certain loan products. There were certainly problems with some adjustable rate and balloon products in the financial crisis. However, these problems should be addressed in a manner that does not inhibit traditional products that banks have managed successfully and that have benefited consumers. The legitimate concerns generated from the poor underwriting and risk management practices of a few institutions should not be addressed through a capital rule applicable to the entire industry. If the proposal is adopted in its current form, the banking industry will enter a counterintuitive phase whereby unsecured loans, which receive a 100% risk-weighting under the proposal, will effectively be deemed safer than many loans secured by collateral, a concept that contradicts the basic principles of banking. Furthermore, the proposed risk-weighting framework will push more residential mortgage business into lines that receive government support, as most government sponsored mortgage programs receive a low risk-weighting under the proposal.

It is critical to acknowledge that while the residential mortgage industry is vast, and a large portion of mortgage activity takes place off banks' books, the volume of residential mortgage exposure held in portfolio at banking organizations is not at all insignificant. Indeed, the commercial banking industry holds over $2 trillion in residential mortgage exposure in portfolio. Notably, residential mortgage exposures comprise an average of 17% of a bank's assets. While the securitization market has become the dominant source of mortgage funding, the assumption that this is not an important exposure for banks is incorrect. A bank's ability to originate and hold residential mortgage product is an important part of its asset mix and allows for a customization of credit beneficial for the consumer. Public policy should not inhibit this activity.

In a period where a coherent plan for addressing broader housing finance reform has not emerged, we believe this proposal, which would limit residential mortgage activity at institutions that are willing to take on the risk associated with this important class of credit, is ill-advised.

HIGH VOLATILITY COMMERCIAL REAL ESTATE (HVCRE)

Current risk-based capital requirements prescribe a 100% risk-weighting for acquisition, development, and construction (ADC) loans. The Agencies have proposed a new risk-weighting for High Volatility Commercial Real Estate (HVCRE) loans. An HVCRE loan would be defined as a credit facility that finances or has financed the acquisition, development, or construction of real property, unless the facility finances one-to four-family residential properties or commercial real estate projects that demonstrate certain LTV or borrower contribution standards. HVCRE loans would receive a 150% risk weighting under the proposal.

The impact of the proposed treatment of HVCRE loans could have negative unintended consequences for banks and the broader economy. The proposed approach, with a highly punitive risk weight, fails to adequately account for an institution's experience and expertise in this type of lending, the adequacy of its policies and procedures, and the level of concentration. Issues with development and construction lending should be addressed at the risk management

level and through the supervisory process. The proposed 150% risk weighting is effectively telling institutions not to engage in this type of lending.

Strikingly, under the proposed rule, sovereign debt that is in default receives the same risk-weighting treatment as the construction and development loans detailed above. Other sovereign debt in substantially struggling countries that are not in default receives a potentially more attractive risk-weighting than HVCRE loans. Considering these relative risk-weightings, the Agencies are effectively signaling to banking organizations that investing in struggling countries such as Greece is as sound as investing in real estate projects in their local communities. This implied direction will cause many banking institutions, particularly community banks, to re-evaluate their asset mix to the detriment of community focused business lending.

We recognize construction and development lending has posed significant risks for many community banks over the past few years. However, as discussed above, to the extent a construction and development loan poses safety and soundness issues for an institution, those issues should be addressed through the supervisory process. The Agencies should not feel compelled to penalize broad types of transactions through capital rules rather than addressing the concentrations that were problematic during the last crisis. Further, it is important to note that while many community banks struggled in their risk assessment of construction and development loans, many more were successful and prudent in construction and development lending. The successful banks frequently established loan concentration limits that forced them to engage in prudent risk selection which recognized the distinct differences within broad loan types. CSBS therefore urges the Agencies to re-contemplate the proposed framework for HVCRE loans.

PAST DUE EXPOSURES

Under current general risk-based capital rules, the risk weighting of an exposure does not change if it becomes past due, with the exception of residential mortgage loans. In the NPR, the Agencies have proposed to require banking organizations to assign a risk-weight of 150% to an exposure that is not guaranteed or not secured if it is 90 days or more past due or on nonaccrual.

This provision will introduce more volatility and potentially sudden shocks into the capital planning process. Additionally, we note that levels of past due exposures may change frequently from quarter to quarter. We should strive to establish provisions that will not cause frequent fluctuations in risk-weighted assets on a quarterly basis.

CSBS would also like to point out that increasing the risk-weighting for past due loans involves some measure of "double-counting." When an exposure becomes past due, there are generally allowance provisions that require institutions to reserve capital for those exposures in case they default, effectively lowering institutions' capital levels. Therefore, increasing the risk-weighting for past due loans will effectively adjust both the numerator and denominator in risk-based capital ratios, compounding the negative effect on the ratio.

Finally, it is important to note that there exist classes of past due loans that are designated as such for administrative reasons. For example, exposures may be past due while institutions are waiting on financial statements, appraisals, or other pertinent financial information. In these cases, institutions will refrain from renewing the loan until the technical issues are resolved. We do not believe institutions should have to hold additional capital against these types of past due exposures.

OFF-BALANCE SHEET EXPOSURES

Within the context of off-balance sheet exposures, the NPR states that if a banking organization provides a credit enhancing representation or warranty on assets it sold or otherwise transferred to third parties, including in cases of early default clauses or premium-refund clauses, the banking organization would treat such an arrangement as an off-balance sheet guarantee and apply a 100% credit conversion factor to the exposure amount. While it appears that standard representations and warranties for fraud, misrepresentation, & documentation deficiencies that have traditionally accompanied secondary market sales of mortgages to investors would be exempted from the risk-based capital requirements, we request the Agencies explicitly clarify whether these traditional representations and warranties are indeed exempt. We believe that requiring institutions to hold capital against these representations and warranties will have detrimental consequences for mortgage banking.

SECURITIZATIONS

Dodd-Frank requires financial regulators to strip references to credit ratings from their regulations. This clearly has an implication for securitizations, as the risk-weighting framework in this area has traditionally referenced credit ratings. Under the proposal, a banking organization would generally calculate a risk-weighted asset amount for a securitization exposure by applying either: (1) the simplified supervisory formula approach (SSFA), or (2) for banking organizations not subject to the market risk rule, a gross-up approach similar to an approach provided under the general risk-based capital rules. Alternatively, a banking organization may choose to apply a 1,250% risk weight to any of its securitization exposures.

We acknowledge that the Agencies are required to adjust their regulations in this area to account for the Dodd-Frank mandate. We would like to note that the proposed approaches for measurement and due diligence requirements, which generally require complex methods of evaluating the underlying collateral in securitizations, may be difficult for community banks to administer, and the alternative proposed risk-weighting is punitive. CSBS encourages the Agencies to explore a simpler method for applying these standards to community banks. We are concerned the proposed approach will significantly impair an institution's ability to manage its balance sheet through the economic cycle. We believe that in order to have a vibrant and diverse banking system, banks of all sizes need the ability to manage the balance sheet with a variety of exposures.

EQUITY EXPOSURES

Under the proposal, a banking organization would determine the risk-weighted asset amount for each equity exposure by multiplying the adjusted carrying value of the equity exposure by

the applicable risk weight set out in the Agencies' proposed Simple Risk-weight Approach Table for equity exposures. The proposal also permits banking organizations to apply a 100% risk weighting to certain equity exposures deemed non-significant.

The Simple Risk-weight Approach Table is straightforward. However, we believe the scope of the 400% equity exposure category applied to non-publicly traded entities should be clarified. We would be particularly concerned if this risk-weighting is assigned to equity exposures such as stock ownership in bankers' banks. It seems that stock ownership in bankers' banks might qualify as a non-significant equity exposure if the ownership meets certain characteristics, thereby achieving a lower risk-weighting. Nevertheless, the industry would benefit from clarity in this area. The Agencies also inquire as to whether they should explore an alternative proposal to simplify the risk-based capital treatment of banking organizations' non-significant equity exposures. We support such an effort.

OTC Derivatives

CSBS requests clarity on what is meant by "netting" within the context of OTC Derivatives in the proposed rule. Netting occurs in many forms. If the proposed rule is simply referring to netting within the context of various master netting agreements, we would like to note that the definition of netting within those agreements can vary widely. To the extent institutions comply with this provision, the Agencies should be aware of the variety of netting arrangements that exist under the master agreements.

Market Discipline and Disclosure Requirements

The Basel Committee on Banking Supervision (BCBS) introduced additional capital disclosure requirements in its 2011 paper entitled, "Definition of Capital Disclosure Requirements." The Agencies are proposing to apply these disclosure requirements to banking organizations with assets greater than $50 billion. CSBS endorses the Agencies' proposed disclosure requirements for large institutions. However, it is important to ensure that these requirements will not flow down to community banks in the future. We generally do not believe that the specific disclosure requirements would be necessary for smaller banks or beneficial to community bank stakeholders.

Regulatory Flexibility Act Analysis

The Regulatory Flexibility Act (RFA), 5 U.S.C. 601 requires an agency to provide an initial regulatory flexibility analysis with a proposed rule or to certify that the rule will not have a significant economic impact on a substantial number of small entities (defined for purposes of the RFA to include banking entities with assets less than or equal to $175 million).

We are troubled by the inconsistent and, in our view, inadequate approach the Agencies took in addressing this requirement. The FDIC and the OCC certify in their analyses that the Basel III and Standardized Approach NPRs, taken together, "appear to have a significant economic impact on a substantial number of small entities." The Federal Reserve's analysis is less conclusive.

Exhibit C

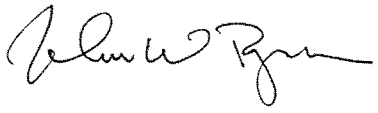
CONCLUSION

The proposed rule provides an important opportunity for the industry and policy makers to debate how various rules should apply to a variety of institutions. The Agencies deserve credit for the extensive outreach they have conducted to ensure the industry understands the proposal. This process should yield the Agencies valuable information on the potential impact that this proposed rule will have on banking operations, access to credit and the broader economy. We believe this is an important opportunity for the Agencies to consider what is realistic and practical for a variety of institutions, appreciating the diversity of the system.

We believe it is important for the capital rules to take a long-term view of the industry and exposures. In this regard, broad risk weights have served regulators reasonably well, with specific information about risk exposures supplemented by supervision. While it can be tempting to attempt to fine tune the risk identification, there is a fine line between enhanced risk sensitivity and credit allocation.

Most importantly, we believe it is imperative to understand the potential impact not only on capital in the banks but also on their behavior in originating credit. An overly conservative industry will not be in the position to serve consumers or local economies. We appreciate that the Agencies must do certain things to comply with the Basel III international accord and the Dodd-Frank Act. The Agencies should pursue a rulemaking with the absolute minimum changes required to comply with the law. We strongly encourage the Agencies to undertake a larger study to evaluate long-term capital standards under a framework which meets the needs of regulators and is consistent with the variety of business models of our banking industry.

Best regards,



John W. Ryan
President & CEO

Exhibit D

Banks and Real Estate Exposures

Banks by Asset Size	# Banks	%	Proportion of RE Exposures	Allocation of RE Exposures 1-4 Family	C&D	CRE	Ag
Less than 100MM	2,375	33%	1%	1%	1%	1%	11%
100MM to 500MM	3,533	49%	6%	6%	14%	14%	38%
500MM to 1 Billion	691	10%	3%	4%	10%	9%	13%
1B to 10 Billion	552	8%	10%	11%	24%	25%	19%
10B to 50 Billion	72	1%	10%	14%	10%	13%	7%
50 Billion +	36	0%	70%	64%	40%	38%	12%
Totals	7,259	100%	100%	100%	100%	100%	100%

Banks by Asset Size	# Banks	Assets (000)	1-4 Family Related Loans $ (000)	% of Assets
Less than 100MM	2,375	135,185,376	25,048,899	19%
100MM to 500MM	3,533	795,179,339	157,219,937	20%
500MM to 1 Billion	691	475,620,093	94,340,971	20%
1B to 10 Billion	552	1,422,243,720	264,904,005	19%
10B to 50 Billion	72	1,414,753,694	339,362,507	24%
50 Billion +	36	9,795,843,302	1,571,946,188	16%
Totals	7,259	14,038,825,524	2,452,822,507	17%

Source: SNL Financial

Marc Jarsulic
Chief Economist
Better Markets, Inc.

Testimony on "Examining the Impact of the Proposed Rules to Implement Basel III Capital Standards."

House Subcommittee on Financial Institutions and Consumer Credit, and the House Subcommittee on Insurance, Housing and Community Opportunity

November 29, 2012

Good afternoon Ms. Chairman Capito, Ms. Chairman Biggert, Ms. Ranking Member Maloney, Mr. Ranking Member Gutierrez, and members of the committee. Thank you for the invitation to Better Markets to testify today.

Better Markets is a nonprofit, nonpartisan organization that promotes the public interest in the domestic and global capital and commodity markets. It advocates for transparency, oversight, and accountability with the goal of a stronger, safer financial system that is less prone to crisis and failure, thereby, eliminating or minimizing the need for more taxpayer funded bailouts. Better Markets has filed more than 100 comment letters in the U.S. rulemaking process related to implementing the financial reform law and has had dozens of meetings with regulators. Our website, www.bettermarkets.com, includes information on these and the many other activities of Better Markets.

My name is Marc Jarsulic and I am the Chief Economist at Better Markets. I have previously served as a Chief Economist of the Senate Banking Committee and Chief Economist and Deputy Staff Director of the Joint Economic Committee. Prior to that I was an academic economist and an attorney specializing in antitrust and securities law.

1. Introduction

I will discuss in detail below the impact of the proposed rules to implement Basel III capital standards and the balance between ensuring financial institutions are properly capitalized and preserving the ability of financial institutions to fulfill their lending and other functions. However, I will first address some of the questions raised by the Committees in their November 16, 2012 letter inviting us to testify.

- **How well capitalized are U.S. financial institutions?**

In large measure, the 2008 financial crisis happened because the too big to fail banks had too much debt and too little equity. Their highly leveraged positions made them vulnerable to asset price declines and creditor runs. When the crisis hit, that massive debt and lack of

equity caused them to fail or almost fail, which required government bailouts that were, in substance, direct or indirect injections of equity.

Capital requirements are the mechanism to address this key flaw in the funding practices of the too big to fail banks. If they are set at adequate levels, then the likelihood of another financial crisis is reduced and, most importantly, the need for taxpayer funded or backed bailouts would be reduced even further.

The crisis also demonstrated that the broker dealers operated by large banks have exceptionally high risk of very rapid counterparty runs. Such broker dealer trading is heavily reliant on repo funding – which is collateralized short term borrowing, often for periods as short as overnight or a single day. These broker dealers with large OTC derivatives books are subject to rapid runs, in which counterparties move the contracts to other dealers, close them out altogether or make margin calls at the first sign of trouble. Because the broker dealers are so highly leveraged, this can create a "cash crunch", forcing assets sales (often leading to "fire sales" at any price to raise the needed cash), which depresses asset prices which forces more sales and causes more collateral calls. This contagion can spread rapidly to other firms, contributing to a systemic event.

Unfortunately, the proposed capital rules do not adequately address these weaknesses. The proposed capital rules do not require too big to fail banks to use sufficient equity finance to insure that they will remain solvent in the face of large asset price declines. Nor do the proposed capital rules require such banks with large broker dealers to self-insure against the run risk posed by OTC derivatives books or repo-financed trading books.

Evidence from the financial crisis indicates that banks must finance 20-25 percent of their assets with equity if they are to survive large asset price declines. The crisis also demonstrated that banks with large broker dealers face run risk that is a function of **gross** repo borrowing and **gross** OTC derivative exposure. Therefore, equity requirements must reflect the risk of these exposures, not some net amount that assumes everything is fully and timely paid.

- **Are uniform capital standards suitable for the diverse financial system in the U.S.?**

The proposed rules do not apply a uniform standard for the diverse U.S. financial system. In fact, the capital standards are tailored to different sizes and types of institutions. For example, the countercyclical capital buffer and other parts of the "Advanced Approaches" rules do not apply to banks with less than $250 billion in assets or $10 billion in on balance sheet foreign exposure.

However, community banks have raised some legitimate concerns about the application of those tailored rules. As discussed below, a few changes to the proposed capital rules should help assure continued community bank credit supply for businesses and households, without significantly increasing the risks to the overall financial system. However, such changes should apply only to genuine community banks, those with assets of $10 billion or less.

- **What will be the cost of compliance if proposed rulemakings go into effect?**

Empirical evidence indicates that there would not be a **social** cost to requiring banks to adequately self-insure against large asset price declines or the run risk created by large broker dealer operations. That is to say, evidence does not support the claim that the cost of bank credit will rise if large banks finance their positions with higher proportions of equity and lower proportions of debt.

Historical evidence suggests that industry claims of excessive or burdensome compliance costs need to be discounted. Moreover, any actual costs need to be balanced against the extraordinary harm inflicted by the financial crisis.

- **Do the proposed rulemakings appropriately address the differences in business models between financial institutions and insurance companies?**

By applying consolidated capital requirements to insurance holding companies, the agencies' Basel III proposal intends to achieve comparable treatment of similar risks across banks and insurers. The example of AIG demonstrates that the behavior of the savings and loan holding companies that own insurers can easily pose threats to overall financial stability. Therefore the proposed treatment of savings and loan holding companies seems very reasonable.

2. The financial crisis revealed important weaknesses of the U.S. banking system.

- First, the U.S. banks use far too much debt, and far too little equity, to finance their positions and operations. This **high leverage** makes them vulnerable to asset price declines and creditor runs.

This can be seen by considering developments at four banks – Washington Mutual, Wachovia, Citigroup and Bank of America– the failure or near failure of which contributed to financial crisis during 2007-2008. The relevant data are presented in Table 1 in the Appendix.

Washington Mutual

Washington Mutual, which failed in the third quarter of 2008 and was acquired by JPMorgan Chase, was, from a regulatory capital standpoint, in good shape as of June 30, 2007. It had total assets of $312 billion, and a ratio of Tier 1 capital to risk-weighted assets of 7 percent (giving a leverage ratio of 14.3). But, by another measure – which was considered the relevant measure during the crisis – Washington Mutual's capital was significantly less robust. The ratio of Washington Mutual's tangible common equity to tangible assets was 4.8 percent (making the leverage ratio, the ratio of assets to equity, 20.7).

As the financial crisis got under way, Washington Mutual began to acknowledge some of its losses, beginning in the third quarter of 2007. Between the third quarter of 2007 and the third quarter of 2008 the cumulative value of Washington Mutual's net charge-offs and asset write-offs totaled $5.9 billion, and the ratio of tangible common equity to tangible assets fell to 3.6 percent (giving a leverage ratio of 27.8). The bank's stock price fell, its borrowing capacity was reduced by the Federal Home Loan Banks and, after Lehman collapsed, there were significant deposit outflows.[1]

Even after all that, the situation at Washington Mutual was in fact much worse than the bank had acknowledged. When JPMorgan Chase acquired the remnants of the bank in September 2008, it wrote off an **additional** $29 billion of Washington Mutual assets.[2] This brought total write-offs to nearly $35 billion, or 11.5 percent of Washington Mutual's tangible assets in June 2007.

Wachovia

A similar scenario played out in the case of Wachovia, one of the ten largest bank holding companies in 2007 with total assets of $703 billion. In the second quarter of 2007 Wachovia's Tier 1 capital was 7.5 percent of its risk-weighted assets. However, its ratio of tangible common equity to tangible assets was 4.3 percent (giving a leverage ratio of 23). Between the second quarter of 2007 and the third quarter of 2008 it recognized cumulative net charge offs and other asset writedowns of $13.1 billion, only 1.9 percent of its second quarter 2007 tangible assets. However, capital markets did not agree with

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1 Offices of the Inspectors General, U.S. Treasury and Federal Deposit Insurance Corporation (2010). Evaluation of Federal Regulatory Oversight of Washington Mutual Bank, Report No. EVAL-10-002, 12-13.

2 JPMorgan Chase (2008). Acquisition of assets, deposits and certain liabilities of Washington Mutual's banks by JPMorgan Chase, September 25, investor presentation.

Wachovia's sunny view of its positions, and in the third quarter of 2008 the bank could no longer borrow in the capital markets and was about to fail.[3]

Wachovia was acquired by Wells Fargo, which wrote off an additional $47.3 billion in assets in 2008Q4. This brought total losses to $60.2 billion, nearly 9 percent of 2007Q2 tangible assets.

Citigroup

Citigroup was on a similar path before it was rescued by massive federal aid. Between the second quarter of 2007 and end of 2008, its ratio of tangible common equity to tangible assets fell from 3 percent (for a leverage ratio of 33) to 1.3 percent (for a leverage ratio of 78.8). This occurred while its regulatory capital ratio was **increasing** from 7.9 percent to 11.9 percent. Citigroup's cumulative charge offs and writedowns were 3.7 percent of its second quarter 2007 tangible assets over this period.

However, in the fourth quarter of 2008 Citigroup had a massive injection of what was in essence government equity. Treasury purchased $45 billion in preferred stock, and the FDIC guaranteed $31.8 billion of Citigroup debt.[4] It clearly needed these public equity injections to survive.[5] Hence, by the fourth quarter of 2008 the total of Citigroup's recognized losses and public equity injections totaled $156 billion, or 7.2 percent of second quarter 2007 tangible assets.

Bank of America

Bank of America had a tangible common equity to tangible assets ratio of 4 percent (and a leverage ratio of 25) in the second quarter of 2007. By the fourth quarter of 2008 the ratio was down to 2.8 percent (for a leverage ratio of 35.3). Cumulative losses amounted to 5.6 percent of it second quarter 2007 tangible assets. By the fourth quarter of 2008 Treasury had purchased $45 billion of Bank of America preferred stock, and FDIC guaranteed $10 billion of the bank's debt. So in the fourth quarter of 2008, the sum of Bank of America's recognized losses and public equity injections totaled 9.3 percent of second quarter 2007 tangible assets.

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[3] Wachovia 10-Q, for the period ended September 30, 2008, 2.

[4] By 2009Q2 debt guarantees rose to more than $72 billion.

[5] The Treasury, Federal Reserve, and FDIC also guaranteed $301 billion of Citigroup assets, and the bank was a large user of Federal Reserve emergency lending facilities. The Congressional Oversight Panel put total federal government exposure to Citigroup at $476.2 billion. *See*, Congressional Oversight Panel (2011). March Oversight Report, Figure 7, *available at* http://cybercemetery.unt.edu/archive/cop/20110401232213/http://cop.senate.gov/documents/cop-031611-report.pdf.

Taken together, these four examples of Washington Mutual, Wachovia, Citigroup and Bank of America clearly demonstrate that banks require equity well in excess of 10 percent of their tangible assets to survive financial crises of the severity we have just witnessed. Losses alone can exceed this amount. And to assure counterparties that they are still viable after such a loss, the bank needs to demonstrate that it will remain viable if it experiences additional losses. Given the fact that assets may devalue rapidly during a crisis, equity equal to 20-25 percent of assets appear necessary for a bank to be self-insured against failure.

- Second, the broker dealers operated by large bank holding companies are highly exposed to risk of very rapid counterparty runs.

Large bank broker dealer **trading** is heavily reliant on repo funding – which is collateralized short term borrowing, often for periods as short as overnight or a single day. It was estimated that in 2007 the 5 largest investment banks funded 42 percent of their assets with repo borrowing. These broker dealers are therefore vulnerable to literal overnight runs when there is severe financial market stress or even the mere threat of stress.[6]

In early 2008 there was a general "run on repo" as firms and asset classes became suspect, even for overnight loans. By the end of the 2008 outstanding repo debt held by primary dealers contracted from a peak value of $4.6 trillion to $2.4 trillion. It is estimated that during the crisis Merrill Lynch, Goldman Sachs, Morgan Stanley and Citigroup lost about 50 percent of their tri-party repo funding, which supported non-agency mortgage backed securities, asset-backed securities and corporate debt.

The collapse of the repo market prompted the Federal Reserve to intervene with the Primary Dealer Credit Facility, Term Securities Lending Facility, and to expand its own repo lending. At its peak, outstanding Federal Reserve lending from these three sources amounted to more than $450 billion.

Broker dealers with large OTC derivatives books are subject to rapid runs, in which counterparties have other dealers step in as counterparties in contracts, close out contracts altogether, or make margin calls. [7] Runs of this kind materialized during the financial crisis at Bear Stearns and Lehman Brothers, contributing to the collapse of those firms. Other

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[6] For a description of the run on repo, *see* the Better Markets comment letter on Volcker Rule, *available at* http://www.bettermarkets.com/sites/default/files/SEC-%20CL-%20Volcker%20Rule-%202-13-12.pdf; for a data on Federal Reserve efforts to aid repo borrowers, *see* http://bettermarkets.com/blogs/another-reason-we-need-strong-volcker-rule.

[7] Financial Crisis Inquiry Commission (2011). The Financial Crisis Inquiry Report, U.S. Government Printing Office, Washington, D.C., 287-288; and D. Duffie (2010). The Failure Mechanics of Dealer Banks, Journal of Economic Perspectives, Volume24,Number 1, 51-72.

large bank broker dealers faced similar risk, which is what necessitated such massive bailouts and rescue programs.

3. The proposed capital rules do not adequately address these weaknesses.

The proposed capital rules do not require banks to use nearly enough equity finance and will allow continued excessively high debt financing, which will continue to pose serious risks of runs that will almost certainly result in the need for bailouts in the future. For example, the proposed rules require banks to hold common equity equal to just 4 percent of on balance sheet assets.[8] But evidence clearly indicates that banks require common equity equal to at least 20-25 percent of their tangible assets to survive a financial crisis of the severity we have just witnessed.[9]

The proposed capital rules do not require banks to self-insure against the run risk posed by OTC derivatives trading or repo borrowing, which means that taxpayers will – again – have to provide the equity for bank bailouts when the next financial crisis happens. For example, the proposed rules allow banks to calculate repo exposures net of the collateral used to borrow, and to calculate derivatives exposures net of counterparty exposures (with a small "potential future exposure" add-on). These **net** calculations do not reflect the fact that runs on repo finance will mean a loss of **gross** repo financing. And, a run by OTC derivatives counterparties will mean an attempt to eliminate **gross** exposure to the weakened dealer. With a financial crisis looming or unfolding, no lender is going to wait until a counterparty nets all its gross positions and exposures to determine if, on a net basis, they are financially sound or not. Any lender is going to call the debt, get their cash and eliminate their exposure as fast as possible.

Instead, equity requirements should rise as trading operations increase their use of repo borrowing or securities lending to fund long maturity assets. They should also rise with gross derivatives exposures. This would require banks to effectively self-insure against runs, and provide some protection against the funding runs that brought down Lehman and Bear Stearns and threatened all the large dealers. It is also a key method to reduce the risk of and need for taxpayer funded or backed bailouts, which were required last time because the too big to fail banks simply did not have enough equity to avoid failure and bankruptcy.

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[8] Federal Register, Vol. 77, No. 169, 52792, Subpart B, §§ __.10(a)(4) and __.10(b)(4).

[9] *See* the Better Markets comment letter on the recently proposed rule changes for more detail, *available at* http://www.bettermarkets.com/sites/default/files/FRS%2C%20OCC%2C%20FDIC-%20CL-3nprs-%2010-22-12.pdf.

4. The social cost of adequate self-insurance against large asset price declines, or the run risk created by large broker dealer operations, is limited.

Empirical evidence indicates that there would not be a **social** cost to requiring banks to adequately self-insure against large asset price declines or the run risk created by large broker dealer operations. If there were, then we should be able to observe a historical correlation between bank equity levels and the cost of bank credit. That is, as bank leverage rises, the markup that banks charge on loans should decline. But as Hanson, Kashyup, and Stein have pointed out, there is no observable correlation between overall bank leverage and bank credit spreads.[10] Therefore there is little reason to expect that the cost of credit for businesses and households would increase if banks were required to finance a larger proportion of their positions and operations with equity.

5. The banking industry has overstated the costs of complying with more stringent standards governing equity finance and controls on run risk. In any event, these heightened requirements are an essential component of reforms designed to prevent another financial crisis.

- History proves that industry claims of excessive compliance costs from financial reform are false

Since the emergence of financial market regulation, the financial services industry has claimed that new regulatory requirements will have a devastating impact by imposing excessive compliance costs or prohibiting profitable activities. Yet the industry has always absorbed the cost of those new regulations and has consistently remained one of the most profitable sectors in our economy. For example, a century ago, when securities regulation first emerged at the state level, Wall Street staunchly opposed it as an "unwarranted" and "revolutionary" attack upon legitimate business that would cause nothing but harm.[11] However, in the years following this early appearance of financial regulation, banks and their profits grew handsomely.[12]

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[10] S. Hanson et al. (2011). A Macroprudential Approach to Financial Regulation. Journal of Economic Perspectives, Volume 25, Number 1, 3-28. *See also* A. Admati and M. Helliwig (2013). The Bankers' New Clothes, forthcoming, for a thorough explanation of why, on the basis of established economic theory, we should expect the liability structure of banks to have very limited impact on the cost of credit.

[11] *See* Marcus Baram, *The Bankers Who Cried Wolf: Wall Street's History of Hyperbole About Regulation*, THE WATCHDOG, HUFFINGTON POST, June 21, 2011, http://www.huffingtonpost.com/2011/06/21/wall-street-historyhyperbole-regulation_n_881775.html.

[12] Paul G. Mahoney, *The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses*, 46 J.L. & ECON. 229, 249 (2003) ("In the 5 years following adoption of a merit review statute [the most stringent type of blue sky law statute], bank profits increased on average by nearly 5 percentage points . . .").

The same pattern has been repeated with each new effort to strengthen financial regulation, including passage of the federal securities laws, deposit insurance, the Glass-Steagall Act, mutual fund reform, and the national market initiatives of the mid-1970s.[13] It continues with full force today, as banks and other financial institutions argue strenuously that many of the reforms in the Dodd-Frank Act will hamper capital formation and credit availability, thus stifling economic recovery. And typically, the industry provides little or no credible data or substantive support for their assertion that regulatory costs will prove to be excessive and unmanageable.[14]

For example, a frequent industry claim is that financial reform rules will "reduce market liquidity, capital formation and credit availability, and thereby hamper economic growth and job creation." Yet the industry fails to mention that the financial crisis did more damage to those concerns than any rule or reform possibly could: Starting in September 2008 and continuing into 2009, there was **no** "market liquidity, capital formation [or] credit availability" and, since then, there has been little "economic growth" and even less "job creation" due to the financial collapse and economic crisis.

The lesson to be learned from this history is that when faced with new regulations, members of the regulated industry routinely argue that the costs and burdens are too heavy—but then they invariably adapt and thrive.[15] Thus, to the extent that banks resist the imposition of more stringent equity ratios and run risk controls on the basis of compliance costs, those arguments must be appropriately discounted.[16]

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[13] Marcus Baram, *supra* note 82; *see also* Nicholas Economides et al., *The Political Economy of Branching Restrictions and Deposit Insurance: A Model of Monopolistic Competition Among Small and Large Banks*, 39 J. L. & ECON. 667, 698 (1996) ("The American Bankers Association fights to the last ditch deposit guarantee provisions of Glass-Steagall Bill as unsound, unscientific, unjust and dangerous. Overwhelmingly, opinion of experienced bankers is emphatically opposed to deposit guarantee which compels strong and well-managed banks to pay losses of the weak . . . .The guarantee of bank deposits has been tried in a number of states and resulted invariably in confusion and disaster . . . and would drive the stronger banks from the Federal Reserve System.") (quoting Francis H. Sisson, president of the American Bankers Association).

[14] Those seeking to block reform are not only exaggerating the impact of regulation, but also submitting incomplete, misleading, or inaccurate cost estimates. *See, e.g.*, John E. Parsons & Antonio S. Mello, *Nera Doubles Down*, Betting Against the Business, Mar. 19, 2012, http://bettingthebusiness.com/2012/03/19/nera-doubles-down/ (challenging industry estimates of the cost of margin requirements in derivatives transactions)

[15] For more analysis of the financial industry's resistance to financial reform, *see* Better Markets, Setting The Record Straight On Cost-Benefit Analysis And Financial Reform At The SEC (July 30, 2012), *available at* http://bettermarkets.com/sites/default/files/CBA%20Report.pdf, incorporated by reference as if fully set forth herein.

[16] Bradley Keoun & Jonathan D. Salant, Obama Plan Gets Wary Reception from Banks, Lawmakers (Update1), BLOOMBERG, June 18, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=ae85nCexF0v0 ("The brewing legislative battle recalls the industry's reluctance to accept reforms after the 1929 stock-market crash. I don't think

- Even if more stringent equity ratios and run risk controls were to impose increased compliance costs on banks, those costs would be warranted to help protect the banking system and the entire economy from another financial crisis.

Over a three-year period beginning in 2007 and culminating in the passage of the Dodd-Frank Act on July 21, 2010, Congress and the President witnessed the financial and economic destruction caused by the financial crisis, implemented emergency measures to contain it, and then made the judgment that comprehensive reforms were essential to protect the financial system and the economy from another financial crisis. The Legislative and Executive Branches determined that the industry would have to bear substantial regulatory burdens to achieve this overriding objective. Those burdens include initial and ongoing compliance costs as well as the elimination of some profitable but high-risk business activities. Congress and the President recognized these consequences but nevertheless imposed them to re-regulate the recently de-regulated financial industry, to close regulatory gaps, and to strengthen existing requirements for the benefit of investors, the public, and the entire economy.[17]

Illustrating this approach, the Dodd-Frank Act imposes a broad set of regulatory reforms on bank holding companies and nonbank financial institutions, with the focus on systemically important institutions. They will pay compliance costs from new requirements relating to registration, reporting, recordkeeping, public disclosures, risk committees, examinations, fees, capital and leverage requirements, and other enhanced supervisory and prudential standards.[18] Key provisions of the statute will also eliminate some immensely profitable trading activities.[19] These statutory bans on profitable

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anyone can buy the argument that by regulating too tightly, we'll choke off capitalism. . . That argument is as shallow now as it was then.") (citing Charles Geisst, Professor, Manhattan College).

[17] For an analysis of the enormous cost and scale of the financial crisis, *see* Better Markets, The Cost of The Wall Street-Caused Financial Collapse And Ongoing Economic Crisis is More Than $12.8 Trillion (Sept. 15, 2012), *available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis_0.pdf.

[18] §§ 112(d) (reporting by Bank Holding Companies & Nonbank Financial Institutions); 114 (registration of Covered Nonbank Companies); 116(a) (Bank Holding Companies with consolidated assets of $50 billion, or Covered Nonbank Companies to submit certified information reports); 161 (reporting by and government examinations of Covered Nonbank Companies); 165(b) (enhanced prudential standards for Covered Bank Holding Companies and Covered Nonbank Companies); 165(d) (reporting by Covered Bank Holding Companies and Covered Nonbank Companies); 165(f) (public disclosures by Covered Bank Holding Companies and Covered Nonbank Companies); 165(h) (risk committee requirements for Publicly Traded Covered Nonbank Companies and Publicly Traded Bank Holding Companies); 165(i) (stress tests to be performed on Bank Holding Companies with consolidated assets of $50 billion, or Covered Nonbank Companies); 210(o) (Orderly Liquidation Fund fees from Bank Holding Companies with consolidated assets of $50 billion, or Covered Nonbank Companies); 619 (Insured Depository Institutions, Bank Holding Companies, and Covered Nonbank Companies to keep records to comply with Volcker Rule).

[19] *See, e.g.*, Provisions on capital requirements for Covered Nonbank Companies, §§ 165(b)-(c), 171; Covered Bank Holding Companies, § 165(b)-(c); Depository Institutions and Depository Institution

activities will effectively eliminate billions of dollars in annual revenue for the largest banks.

These reforms are necessary to bring integrity and stability to the financial markets. It is clear that these reforms would be impossible to implement without imposing compliance costs on market participants, who will be required to pay filing fees, hire new staff, upgrade and maintain information technologies, reallocate capital, and alter their business procedures. In passing the Dodd-Frank Act, both Congress and the President decided that the enormous collective benefits of the law far exceeded any costs or lost profits that industry would have to absorb. Similarly, the imposition of heightened standards governing equity finance and run risk controls on banks is clearly warranted as a key component of the reforms that must be implemented to more effectively safeguard our markets and our economy from another crisis.

6. Any adjustments to the capital requirements for "community banks" should be restricted to a properly defined set of banks.

The banking agencies have indicated that the capital rules may need some changes to account for issues that are specific to community banks. For example, in a speech on October 23, Comptroller Thomas Curry cited two issues that might merit additional consideration.[20] The Comptroller noted that "some aspects of provisions pertaining to mortgages could impose a serious burden on community banks and thrifts, particularly when applied to existing mortgages or if phased in too quickly." He also said that the proposed treatment of unrealized gains and losses on available for sale securities could create volatility in regulatory capital that would be difficult to manage for banks that "...do not regularly access the short term capital markets." Also, Federal Reserve Governor Elizabeth A. Duke argued on November 9 for providing a separate set of rules for mortgage lending by community banks.[21]

Some rule changes may help assure continued community bank credit supply for businesses and households without significantly increasing the risks to the overall financial system. For example, it may be reasonable to grandfather existing portfolios of mortgages from proposed new risk weights for mortgages outside "category 1." It may also make sense to phase in the requirement that fair value changes in "available for sale securities" holdings are reflected in calculations of Tier 1 capital. That would give community banks

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Holding Companies, § 171; Bank Holding Companies, Savings and Loan Holding Companies, & Depository Institutions, § 616; Supervised Securities Holding Companies, § 618(d); and Covered Nonbank Companies engaging in activities covered by Volcker Rule, § 619.

[20] Remarks by Thomas J. Curry, before the Florida Bankers Association, October 23, 2012, *available at* http://www.occ.gov/news-issuances/speeches/2012/pub-speech-2012-151.pdf

[21] Community Banks and Mortgage Lending, Remarks by Elizabeth A. Duke, Member Board of Governors of the Federal Reserve System, at the Community Bankers Symposium, November 9, 2012, *available at* http://www.federalreserve.gov/newsevents/speech/duke20121109a.htm

time to adjust their securities holdings and to reduce potential regulatory capital volatility. And there may be circumstances where the definition of qualified mortgages can be adjusted to meet the special circumstances faced by community banks. For example, the Dodd-Frank Act allows, under certain circumstances, "balloon" mortgages made by banks operating in rural or underserved areas to be treated as qualified mortgages.[22]

However, such changes should apply only to genuine community banks. To prevent too-big-to-fail banks that pose systemic risks from avoiding regulation appropriate to them by hiding behind community bank concerns, it is essential to properly define a community bank.[23] If community banks are defined as those with assets less than $1 billion, then community banks comprise 91 percent of all FDIC insured institutions. If the asset threshold for a community bank were to be generously raised to $10 billion, then community banks comprise more than 98 percent of all banks. [24]

For present purposes, Better Markets would suggest that individual banks or bank holding companies with assets of $10 billion or less should be considered community banks. Such a definition would mean that, with the exception of some small banks in multiple-bank holding companies, 98 percent of all individual banks would be considered community banks.[25]

Thus, 98 percent of all individual banks would have the impact of implementing Basel III addressed as discussed above.

7. Consolidated capital requirements for insurance holding companies will enhance overall financial stability

By applying consolidated capital requirements to insurance holding companies, the agencies' Basel III proposal intends to achieve comparable treatment of similar risks across banks and insurers. This is an important goal. Even if major subsidiaries in a holding

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[22] Dodd-Frank Act, section 1412(2)(E).

[23] Researchers often define community banks as those that serve limited geographical markets, depend on retail deposits for much of their funding, and have assets of $1 billion or less. *See*, e.g., G. Kahn et al. (2003). The Role of Community Banks in the U.S. Economy, Economic Review, Federal Reserve Bank of Kansas City, Second Quarter, 17; T. Critchfield et al. (2004). Community Banks: Their Recent Past, Current Performance, and Future Prospects, FDIC Banking Review, 2.

[24] See the data in Table 2, attached. The data in the Table cover individual banks. Some banks may be subsidiaries of holding companies that control more than one bank. Hence the number of holding companies would be somewhat smaller than the number of individual banks, and the distribution of holding company assets will differ somewhat from the data presented here. Data on smaller bank holding companies are not readily available.

[25] *Id.*; *see also*, Remarks by Elizabeth A. Duke, Member Board of Governors of the Federal Reserve System, at the Community Bankers Symposium, November 9, 2012, *available at* http://www.federalreserve.gov/newsevents/speech/duke20121109a.htm (using an asset threshold of $10 billion to identify community banks).

company engage in property casualty insurance or asset management, they can also engage in securities trading, OTC derivatives transactions, and securities lending at the holding company level.

The example of AIG – where high risk investments financed with securities lending, and a huge portfolio of CDS unsupported by equity both contributed to a systemically damaging failure – demonstrates that the behavior of such holding companies can easily pose threats to overall financial stability.

The proposed regulations do take account of the differences between insurers and others. Separate accounts that do not guarantee results to investors have a zero risk weights for regulatory capital purposes, and policy loans receive a low risk weight.

Therefore, the proposed treatment of savings and loan holding companies seems very reasonable.

Table 1

Washington Mutual

quarter	Total Assets	Goodwill	Intangibles	Common Equity	Preferred Stock	Tangible Common Equity (TCE)	Tangible Assets (TA)	TCE/TA (percent)	TCE Leverage ratio	Tier 1 capital	Tier 1/(Risk Weighted Assets) (percent)
2007q2	312.2	9.1		24.2	0.5	15	303.2	4.84	20.7	21	7.0
2007q3	330.1	9.1		23.9	0.5	14	321.0	4.48	22.3	20	7.6
2007q4	327.0	7.3		24.6	3.4	14	319.7	4.35	23.0	22	8.3
2008q1	319.7	7.8		22.4	3.4	11	311.8	3.60	27.8	22	8.1
2008q2	309.7	7.3		26.1	3.4	15	302.4	5.10	19.6	21	8.4

quarter	Net Loan Charge-Offs	Other Asset Writedowns	Total Writedowns	Cumulative Writedowns	Cumulative Writedowns (percent)*
2007q2					
2007q3	0.206	1.0	1.4	1.4	0.6
2007q4	0.461	0.3	1.0	2.4	1.0
2008q1	0.765	2.1	1.0	3.4	1.3
2008q2	1.309	3.7	2.0	5.4	1.9
2008q3			29	34.4	11.5

* = 100*(cumulative writedowns/tangible assets 2007q2)

Data from SEC 10Q and 10K's, and FR Y9-C's. Unless otherwise noted, data in current $ billions.

Table 1, contd.

Bank of America

quarter	Total Assets	Goodwill	Intangibles	Common Equity	Preferred Stock	Tangible Common Equity (TCE)	Tangible Assets (TA)	TCE/TA (percent)	TCE Leverage ratio	Tier 1 capital	Tier 1/(Risk Weighted Assets) (percent)
2007q2	1,534.4	65.8	8.7	135.8	2.9	58.3	1,459.8	4.0	25.0	92.4	
2007q3	1,578.8	67.4	9.6	138.5	3.4	58.0	1,501.7	3.9	25.9	92.4	8.2
2007q4	1,715.7	77.5	10.3	146.8	4.4	54.6	1,627.9	3.4	29.8	89.2	6.9
2008q1	1,736.5	77.9	9.8	156.3	17.3	51.3	1,648.8	3.1	32.1	99.1	7.5
2008q2	1,716.9	77.8	9.6	162.7	24.2	51.2	1,629.5	3.1	31.8	106.9	8.3
2008q3	1,831.2	81.8	9.2	161.0	24.2	46.0	1,740.3	2.6	37.9	137.4	7.6
2008q4	1,817.9	81.9	8.5	177.1	37.7	48.9	1,727.5	2.8	35.3	118.8	8.9

quarter	Net Loan Charge-Offs	Other Asset Writedowns	Total Writedowns	Cumulative Writedowns	Cumulative Writedowns (percent)*
2007q3	6.8	2	8.7	8.7	0.6
2007q4	3.8	18.1	21.9	30.7	2.1
2008q1	3.8	10.8	14.6	45.3	3.1
2008q2	4.4	7.2	11.6	56.9	3.9
2008q3	4.7	6.5	11.2	68.1	4.7
2008q4	6.2	6.9	13.1	81.2	5.6

TARP Preferred Stock Purchases	TLGP Debt Guarantees	Cumulative Writedowns + TARP + TLGP	Cumulative Writedowns + TARP + TLGP (percent)**
45	10	136.2	9.3

* = 100*(cumulative writedowns/tangible assets 2007q2)

** = 100*((cumulative writedowns+TARP+TLGP)/tangible assets 2007q2)

Data from SEC 10Q and 10K's, and FR Y9-C's. Unless otherwise noted, data in current $ billions.

Table 1, contd.

Citigroup

quarter	Total Assets	Goodwill	Intangibles	Common Equity	Preferred Stock	Tangible Common Equity (TCE)	Tangible Assets (TA)	TCE/TA (percent)	TCE Leverage ratio	Tier 1 capital	Tier 1/(Risk Weighted Assets) (percent)
2007q2	2220.9	39.2	23.0	127.8	0.6	64.9	2158.7	3.0	33.2	92.4	
2007q3	2358.3	39.9	23.7	127.1	0.2	63.3	2294.7	2.8	36.2	92.4	7.3
2007q4	2187.6	41.2	22.7	123.0	1.0	58.1	2123.7	2.7	36.6	89.2	7.1
2008q1	2199.8	43.6	23.9	128.2	19.4	41.3	2132.3	1.9	51.7	99.1	7.7
2008q2	2100.4	43.3	24.5	136.4	27.4	41.2	2032.6	2.0	49.4	106.9	8.7
2008q3	2050.1	39.7	23.5	126.1	27.4	35.5	1987.0	1.8	56.0	137.4	8.2
2008q4	1938.5	27.1	19.8	141.6	70.7	24.0	1891.5	1.3	78.8	118.8	11.9

quarter	Net Loan Charge-Offs	Other Asset Writedowns	Total Writedowns	Cumulative Writedowns	Cumulative Writedowns (percent)*	TARP Preferred Stock Purchases	TLGP Debt Guarantees	Cumulative Writedowns + TARP + TLGP	Cumulative Writedowns + TARP + TLGP (percent)**
2007q3	2.6	2	4.6	6.5	0.3				
2007q4	3.8	18.1	21.9	28.5	1.3				
2008q1	3.8	10.8	14.6	43.1	2.0				
2008q2	4.4	7.2	11.6	54.7	2.5				
2008q3	4.7	6.5	11.2	65.9	3.1				
2008q4	6.2	6.9	13.1	79.0	3.7	45	31.8	155.8	7.2

* = 100*(cumulative writedowns/tangible assets 2007q2)

** = 100*((cumulative writedowns+TARP+TLGP)/tangible assets 2007q2)

Data from SEC 10Q and 10K's, and FR Y9-C's. Unless otherwise noted, data in current $ billions.

Table 1, contd.

Wachovia

quarter	Total Assets	Goodwill	Intangibles	Common Equity	Preferred Stock	Tangible Common Equity (TCE)	Tangible Assets (TA)	TCE/TA (percent)	TCE Leverage ratio	Tier 1 capital	Tier 1/(Risk Weighted Assets) (percent)
2007q1	702.7	38.8	1.6	69.8		29	662.3	4.44	22.5	41.5	7.5
2007q2	715.4	38.8	1.5	69.3		29	675.2	4.30	23.3	41.9	7.1
2007q3	754.2	38.8	1.4	70.1		30	713.9	4.19	23.9	43.5	7.4
2007q4	782.9	43.1	2.1	76.9	2.3	29	737.7	3.98	25.1	43.5	7.4
2008q1	808.6	43.1	2.0	78.0	5.8	27	763.5	3.55	28.2	45.4	7.4
2008q2	812.4	37.0	1.9	75.1	5.8	30	773.5	3.93	25.5	49.5	8.0
2008q3	764.4	18.4	1.9	50.0	9.8	20	744.2	2.68	37.3	43.8	7.5

quarter	Net Loan Charge-Offs	Other Asset Writedowns	Total Writedowns	Cumulative Writedowns	Cumulative Writedowns (percent)*
2007q2			0.2		
2007q3	0.2		0.2	0.2	0.0
2007q4	0.5	2.7	3.2	3.4	0.5
2008q1	0.8	2.3	3.1	6.4	1.0
2008q2	1.3	0.9	2.2	8.7	1.3
2008q3	1.9	2.5	4.4	13.1	1.9
2008q4			47.3	60.4	8.9

* = 100*(cumulative writedowns/tangible assets 2007q2)

Data from SEC 10Q and 10K's, and FR Y9-C's. Unless otherwise noted, data in current $ billions.

Table 2

	All FDIC Insured Institutions	Less than $100 Million	$100 Million to $1 Billion	$1 Billion to $10 Billion	Greater than $10 Billion
number of institutions reporting	7,246	2,342	4,244	553	107
total assets (in billions)	14, 031	135.4	1274.7	1425.9	11, 195.0
percent of all banks		32.3	58.6	7.6	1.5
percent of total assets		1.0	9.1	10.2	79.9

Banks with assets of **$1 billion or less** comprise **91** percent of all banks and hold **10** percent of total assets

Banks with assets of **$10 billion or less** comprise **98.6** percent of all banks and hold **20.3** percent of total assets

Source: FDIC Quarterly Banking Profile, Second Quarter 2012



Testimony of

William A. Loving

President and CEO of Pendleton Community Bank

Franklin, WV

On behalf of the

Independent Community Bankers of America

Before the

United States House of Representatives

Committee of Financial Services

Subcommittee on Financial Institutions and Consumer Credit

and

Subcommittee on Insurance, Housing, and Community Opportunity

Hearing on

"Examining the Impact of the Proposed Rules to Implement Basel III Capital Standards"

November 29, 2012

Washington, D.C.

Opening

Chairman Capito, Chairman Biggert, Ranking Member Maloney, Ranking Member Gutierrez and members of the subcommittees, my name is William A. Loving, Jr., and I am President and CEO of Pendleton Community Bank, a $260 million asset bank in Franklin, West Virginia that serves four rural markets in West Virginia and one Virginia community. I am also Chairman-elect of the Independent Community Bankers of America and I testify today on behalf of its nearly 5,000 members. Thank you for convening this hearing on a topic of existential importance to the community banking industry, the Basel III proposed capital rules.

We are grateful to the many members of the Financial Services Committee who have sent letters to the banking regulators expressing their serious concerns about the impact of Basel III and the standardized approach on community banks. It is no exaggeration to say that these rules could bring about the demise of the community banking industry within a decade. No topic has caused such alarm among community bankers in recent memory – as demonstrated by their estimated 2,000 individually-written comment letters on the proposed rules and their potential impact on their communities. In addition, nearly 15,000 individuals have signed an ICBA petition urging the banking regulators to provide an exemption for banks with assets of less than $50 billion. Today, we urge Congress to support such an exemption and protect the community bank model – one essential to communities all across our great nation.

In this testimony I will detail community banks' concerns with Basel III and the standardized approach, but let me summarize those concerns here. The proposed rules penalize customized lending without regard to asset quality. This strikes at the community bank competitive advantage – customized, relationship-based lending – in an industry that is increasingly dominated by a small number of large banks offering commoditized lending. A second broad objection is this: New, unnecessarily high capital requirements are simply not viable for community banks because we have extremely limited options for raising new capital, unlike our larger competitors. Without access to the public markets, community banks must rely on other limited means to raise new capital. In particular, mutual community banks, which are among the safest institutions, must rely exclusively on retained earnings to raise capital. With historically low interest rates, compressed interest margins make it very difficult to accumulate retained earnings. Finally, the proposed rules will introduce volatility into regulatory capital where stability is an important indicator of financial health.

Basel III was meant to apply to the largest, interconnected, internationally active and systemically important institutions. Community banks, with their simple capital structures and conservative funding and lending practices, have nothing in common with these larger institutions. Applying the same regulatory capital standards to community banks – in a one-size-fits-all fashion – in addition to the many other new regulations that are becoming effective, will simply make community banking a losing proposition for many, triggering thousands of bank sales. Mass consolidation will make the banking industry less competitive for consumers and businesses. The small towns and rural areas currently served by community banks for credit will face curtailed access to credit and economic stagnation.

Let's not take a step that will fundamentally alter the nature of the financial services industry. Our national economy needs a diverse, competitive financial services sector with large and regional banks as well as thriving community banks offering real choice, including customized products, to consumers and small businesses alike. An economy dominated by a small number of large banks wielding undue market power and offering commodity products would not provide the same level of competitive pricing and choice. Promoting and sustaining a vibrant community banking sector is an important public policy goal. Basel III and the standardized approach contravene this goal, posing an existential threat to community banks.

The case for a total exemption for community banks from Basel III and the standardized approach is illustrated by two particularly troubling provisions.

Standardized Approach Risk Weights

New risk weights on certain residential mortgages will impose punitive capital charges on all but standardized, "plain vanilla" loans. What's more, because of their complexity – there are eight different risk weightings for residential mortgages – the new risk weights will be exceedingly difficult to comply with without incurring significant software upgrades and other operational costs. Mutual banks will be disproportionately impacted because, as thrifts, they hold more mortgage loans than other community banks. Customized home loans like balloon loans – a staple of community banking – as well as second liens will be severely penalized with new capital constraints during a fragile housing recovery. Under the proposed standardized approach, balloon loans would move from their current 50% risk weight to a potential mind-boggling 200% risk weight all while being fully secured by real estate. Balloon loans are the best mortgage option for many community banks and their customers for any number of sound reasons. For example, a loan may be ineligible for sale into the secondary market because it's collateralized by an irregular, rural property without adequate comparables. I'm happy to hold such loans in my portfolio but the only way I can protect my bank against interest rate risk is to structure the transaction as a balloon loan with a five to seven year maturity or an Adjustable Rate Mortgage (ARM), a product which carries its own set of customer concerns and regulatory reporting issues. Without the balloon loan option, many rural customers will be unable to finance home purchases or home improvements. I and other community bankers have safely offered balloon loans for decades. Because I retain these loans as well as other loan types in portfolio, I have a vested interest in their performance and I take care to ensure that they are underwritten to the highest standards. I am not aware of any data whatsoever that demonstrates that balloon loans are more risky than other types of credit.

Second liens like home equity loans and home equity lines of credit help to provide borrowers with the flexibility they need and are a major contributor to economic growth throughout the country. Although these loan products are often cited as an example of the past economic excesses of reckless homeowner leverage, prudently underwritten second liens serve a very important and vital role in the lives of homeowners and the overall economy. These loan products are frequently used by homeowners to finance property improvements, send a child to college, and start a small business.

The new proposed risk weights strike right at the heart of the community banking model. Our direct knowledge of the community and the borrower allows us to underwrite loans tailored to their unique needs – loans that larger lenders are unwilling to make.

Treatment of Accumulated Other Comprehensive Income

The Basel III proposal requiring banks to include in regulatory capital accumulated other comprehensive income (AOCI) will significantly misrepresent community banks' capital positions. AOCI, a component of shareholders' equity that for most community banks represents unrealized gains and losses on certain investment securities, is currently excluded from regulatory capital and its inclusion will introduce unnecessary volatility into a community bank's capital position. Most community banks, including Pendleton Community Bank, have large positive AOCI balances as a result of historically low interest rates. Today's low interest rate environment, coupled with the "flight to quality" on U.S. government debt by risk adverse investors, has driven up the value of debt securities and increased unrealized gains in many portfolios. These sources of unrealized gains are not sustainable. When economic growth accelerates and interest rates inevitably rise, debt securities will drop in value and AOCI will quickly turn negative. This pending shift in AOCI says nothing about a bank's ability to absorb losses and should not be reflected in its regulatory capital. To use my bank as an example, a 300 basis points increase in interest rates (a reasonable scenario given the magnitude of the fall in rates since 2007) would cause my bank's bond portfolio to show a net paper loss of $2 million. My bank's tier one capital would drop 11.03 percent and the bank's tier one risk based capital ratio would decrease 9.92 percent – from 14.01 percent to 12.62 percent if AOCI was included. While the ratio would remain above minimum regulatory levels, both now and proposed, many other community banks would experience much larger paper losses and sharper drops in capital and ratios. Even banks such as mine that would not become undercapitalized will be forced to reassess their business strategies and plans for growth to preserve capital. The expected rise in interest rates is just one source of fair value change that will cause capital volatility. Changes in credit spreads and other market developments will have a similar impact. To avoid becoming undercapitalized, banks will need to maintain an additional capital cushion of 2 to 3 percent, depending on the economic environment.

Larger banks have tools at their disposal, such as interest rate derivatives, to minimize the impact of AOCI on regulatory capital. This gives the larger banks a competitive advantage over community banks because they can more readily absorb the overhead necessary to engage in derivatives trading. Community banks have limited ability to carry interest rate derivatives on their balance sheets due to the increased resources needed to maintain these risk mitigation activities. Because of this disadvantage, community banks are disproportionately impacted by the inclusion of AOCI in regulatory capital.

The inclusion of AOCI in regulatory capital will undermine community bankers' ability to maintain capital levels that are not only adequate but stable – an important indicator of bank health to the public, depositors, borrowers, investors, counterparties, and regulators.

I've highlighted the impact of just two provisions – risk weights and the inclusion of AOCI in regulatory capital – to illustrate why community banks must be exempt from Basel III and the standardized approach. Many additional provisions are nearly as troubling, and the cumulative impact, as I have stated, would effectively bring about the end of the community banking

industry within a decade. There's just too much wrong with this rule for it to be adequately addressed with a few discreet amendments. Only a full exemption will adequately address our concerns and ensure the long-term viability of our industry.

ICBA Recommended Modifications

Absent a total exemption for banks with less than $50 billion in assets, ICBA strongly favors the following modifications to Basel III to simplify the rule and better align the proposed capital standards to the unique strengths and risks of community banking:

- Banks under $50 billion in assets should be exempt from the standardized approach for risk weighted assets. The standardized approach's complex and punitive risk weighting for residential mortgages could force community banks out of this line of business.
- Unless it can be empirically shown that these assets are risky, the proposed substantially higher risk weights for balloon mortgages and second mortgages should be reduced to their current Basel I levels. Basel I risk weighting better reflects the high-quality nature of this asset class.
- AOCI should continue to be excluded from the calculation of regulatory capital for banks under $50 billion in assets to avoid harmful and unnecessary volatility in capital adequacy.
- If AOCI is not excluded from the calculation of regulatory capital for community banks, then changes in the fair value of all obligations of the U.S. government, mortgage-backed securities issued by Fannie Mae and Freddie Mac, and all municipal securities should be exempt. These securities are deemed to be risk free and are essential to maintaining a healthy housing market. For community banks, this change would greatly simplify the process of computing AOCI and significantly reduce capital volatility.
- Consistent with the Collins Amendment of the Dodd-Frank Act, bank regulators should continue the current Tier 1 regulatory capital treatment of TruPS issued by bank holding companies with consolidated assets between $500 million and $15 billion. This change would reflect Congressional intent and reduce the capital burden for community banks. Many community banks have based their long-term capital planning on the permanent grandfather provisions of the Collins Amendment. Four hundred eighty five institutions with between $500 million and $10 billion in assets depend on TruPS for 13.33 percent of Tier 1 capital.
- Consistent with the proposal for bank holding companies, the Federal Reserve should exempt all thrift holding companies with assets of $500 million or less from Basel III and the standardized approach or provide a policy rationale for why they are not exempt.
- The allowance for loan and lease losses (ALLL) should be included in Tier 1 capital in an amount up to 1.25% of risk weighted assets and the remaining balance of ALLL should qualify for inclusion in Tier 2 capital so that the entire ALLL will be included in a community bank's total capital. Delinquent loans are essentially "double reserved," taking into account both ALLL and the proposed rules' significantly higher capital requirements for such loans. Our recommended change will at least give proper recognition to the loss-absorbing capacity of the ALLL.
- Mortgage servicing assets should be subject to the current higher deduction thresholds because they do not pose a risk to community bank capital. The punitive deduction thresholds set forth in the proposed rule will discourage community banks from retaining

servicing rights and will accelerate consolidation in the servicing industry. Community banks provide high quality, personalized servicing that reduces foreclosures. They should be encouraged to remain in the business.

- Community banks should be exempt from the provisions of the capital conservation buffer because they have no vehicle, such as the equity markets, for raising capital quickly. This is particularly important for the 2300 Subchapter S community banks. Subchapter S owners owe tax on the bank's earnings and they rely on distributions, which would be put at risk by the provision of the capital conservation buffer, to pay these tax bills. Alternatively, the phase-in period for the capital conservation buffer should be extended by at least three years to January 1, 2022 to provide community banks with enough time to meet the new regulatory minimums.
- The proposed risk weights for equity investments should be substantially simplified so community banks will not be discouraged from investing in other financial institutions such as banker's banks, which are key business partners in community bank lending.
- In the absence of a full exemption from the standardized approach, any changes to the risk weights should be applied prospectively to give community banks enough time to comply.
- Regulators should make accommodations to ensure Basel III and the standardized approach do not negatively impact the nation's minority banks and the diverse and sometimes economically stressed and underserved communities they serve. Minority banks should be preserved and promoted.
- If Basel III and the standardized approach are to apply to community banks, then they should also apply to credit unions. The credit union tax exemption already gives them a significant competitive advantage over tax-paying banks. That advantage should not be exacerbated by allowing credit unions to comply with much less rigorous capital standards that will allow them to offer low rates on loans and rates on deposits.

Again, the most sensible and prudent policy, the policy that would avoid severe unintended consequences, would be an outright exemption for financial institutions with assets of less than $50 billion. Basel III was originally intended to apply only to large, complex, and internationally-active institutions. Applying Basel III more broadly in a one-size-fits-all manner would harm all consumers and businesses that rely on credit and the impact would be especially harsh in small communities and rural areas not served by larger institutions.

ICBA encourages this committee to consult our October 22 comment letter to the banking regulators for more detail substantiating the above views. (The ICBA letter is available at: http://www.icba.org/files/ICBASites/PDFs/cl102212.pdf.)

Closing

Thank you again for convening this important hearing and helping to raise the profile of a significant economic policy issue with far reaching and perhaps unappreciated implications. Your letters to the bank regulators, both in their thoughtful quality and their sheer number, have made a significant impression. We look forward to working with this committee to obtain a full exemption from Basel III and the standardized approach for banks with less than $50 billion in assets.

For Release Upon Delivery
10:00 a.m., November 29, 2012

TESTIMONY OF
JOHN C. LYONS
SENIOR DEPUTY COMPTROLLER BANK SUPERVISION POLICY
and
CHIEF NATIONAL BANK EXAMINER
OFFICE OF THE COMPTROLLER OF THE CURRENCY
Before the
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
And the
SUBCOMMITTE ON INSURANCE, HOUSING AND COMMUNITY OPPORTUNITY
U.S. HOUSE OF REPRESENTATIVES

November 29, 2012

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Chairman Capito, Ranking Member Maloney, Chairman Biggert and Ranking Member Gutierrez, and members of the Subcommittees, thank you for your invitation to testify. I appreciate the opportunity to appear before you today to discuss the three proposed capital rules released by the federal banking agencies (the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board, and the Federal Deposit Insurance Corporation) in June, and in particular, the impact of those proposed rules on national banks and federal savings associations and the stability of the U.S. financial system.

During the public comment period for these proposals that ended on October 22, 2012, the OCC and the other federal banking agencies received approximately 1,500 comment letters from banks and federal savings associations of all sizes. In light of the number of comments received and the important issues raised, the agencies announced earlier this month that we do not expect to finalize the proposals by January 1, 2013. While we are still in the process of reading and assessing the comments, it appears that the most fundamental issues have been raised by small banks and federal savings associations (collectively, community banks) who have raised concerns about the applicability of the standards to them. Large banks have raised some of the same concerns as the community banks in terms of specific provisions contained in the proposals as well as additional concerns that are more technical in nature. Since our comment review process is in early stages, there are some limitations on the views I can express to avoid prejudging the outcome of the rulemaking process.

We are committed to carefully considering all the comments we received; however, my testimony today will focus on some of the overarching concerns raised, and in particular, those raised by community bankers. In this regard, I want to assure you that we are very cognizant of the special role that smaller banks play in our communities and in providing financing of our country's small businesses and families.

It's important to start by noting that the key reason that we issued the proposals was to improve the safety and soundness of our nation's banking system. Strong capital standards have played an important role in moderating downturns and positioning the banking system to serve as a catalyst for recovery by ensuring that financial institutions stand ready to lend throughout the

economic cycle. Access to credit by businesses and consumers is critically important to promoting and achieving financial stability. The recent crisis demonstrated the consequences of having insufficient capital in the banking system of the U.S. and around the world.

The international Basel III agreements embraced many of the lessons learned during the crisis relating to regulatory capital. As members of the Basel Committee on Banking Supervision, the agencies worked to develop these enhanced capital standards, and the elements contained in the Basel III international framework are reflected in much of what we have proposed to apply in the U.S. As the OCC has previously testified, many of the key provisions and objectives of Basel III complement key capital provisions of the Dodd-Frank Act.[1] However, in developing the U.S. capital proposals, we did not adopt a "one-size fits all approach." We carefully evaluated each element of the Basel III framework and assessed to which banks it should be applied. In making these assessments, the agencies strove to calibrate the requirements to reflect the nature and complexity of the financial institutions involved. As a result, and consistent with the higher standards for larger banks required by section 165 of the Dodd-Frank Act, many of the provisions in the proposed rules are only for larger banks and those that engage in complex or risky activities; community banks with more basic balance sheets are largely or completely exempted. While the international Basel III agreements incorporate many of the lessons learned from the crisis, there were other key concerns that were not addressed in those standards, but which are important for promoting the resiliency and stability of the U.S. banking system – for example, the importance of better differentiating risks in mortgage lending. The U.S. proposed rules attempt to address these additional elements as well.

We recognize that the proposed changes represent a comprehensive reform of regulatory capital standards and that the burden of reviewing and assessing the impact of new regulatory proposals can weigh especially heavily on community banks. This is why we have taken several measures to reduce the burden of this rulemaking process for these banks – in the way we

[1] Testimony of John Walsh, Acting Comptroller of the Currency, before the Committee on Banking, Housing, and Urban Affairs, United States Senate (March 22, 2012).

organized the proposals, in outreach we have conducted, and by distributing a tool to help bankers assess the potential impact of the proposals on their capital requirements.

We also appreciate that the burden for community banks lies not only in reviewing and understanding the proposals, but also in complying with them. In this context, it is important to remember that these are proposed rules, not final rules, and we are very interested in feedback on all aspects of these proposals. We posed over 80 specific questions in the proposals, including questions related to regulatory burden, to elicit comments on all aspects of the proposals.

In my testimony today, I will review briefly the proposed capital rules and then discuss three of the major issues raised in the comments we have received. These issues are: (1) the overall complexity of the proposals and questions about their applicability to, and appropriateness for, community banks; (2) the proposed treatment of unrealized losses (and gains) in regulatory capital; and (3) the treatment of real estate lending, particularly residential mortgages.

The Proposed Capital Rules

In June, the agencies published three notices of proposed rulemaking (NPRs) – the Basel III NPR, the Standardized Approach NPR, and the Advanced Approaches NPR.[2] Many, but not all, of the provisions contained in two of these three NPRs – the Basel III NPR and the Standardized Approach NPR – would apply to all banks, including community banks.

The Basel III NPR would raise the quantity and quality of capital required to meet minimum regulatory standards. The Standardized Approach NPR seeks to address shortcomings in the way capital is aligned with risks in our current rules. The Advanced Approaches NPR would require the largest banks, when calculating regulatory capital, to take a more complete and accurate account of their risks, both on- and off-balance sheet. The Basel III and Advanced

[2] "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action" (Basel III NPR), 77 Fed. Reg. 52792; "Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements" (Standardized Approach NPR), 77 Fed. Reg. 52888; and "Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule" (Advanced Approaches NPR) 77 Fed. Reg. 52978.

Approaches NPRs would significantly raise capital standards for large banks. Taken together, the three NPRs address the risks that contributed to the recent financial crisis and aim to enhance the safety and soundness of the U.S. banking system.

Turning to the first of the three NPRs, the Basel III NPR concentrates largely on improving the reliability with which banks of all sizes can absorb future losses. It covers both the definition and the minimum required levels of capital. The NPR proposes a new measure for regulatory capital called Common Equity Tier 1 (CET1). This measure was introduced because some of the instruments that qualified under the broader existing definitions of regulatory capital did not dependably absorb losses during the crisis and the subsequent economic downturn.

The proposed minimum standard for CET1 is 4.5 percent of risk-weighted assets. On top of this, the NPR introduces two new capital buffers – the capital conservation buffer and the countercyclical buffer.

The proposed capital conservation buffer is 2.5 percent of risk-weighted assets, which would bring the effective CET1 requirement up to 7 percent of risk-weighted assets. If a bank's CET1 ratio were to fall below that level, capital distributions and discretionary bonus payments would be restricted. This buffer would apply to banks of all sizes. During the recent financial crisis and economic downturn, some banks continued to pay dividends and substantial discretionary bonuses even as their financial condition weakened; the capital conservation buffer is intended to limit such practices and conserve capital at individual banks and for the banking system as a whole.

The countercyclical capital buffer would apply only to the largest internationally-active banks with assets in excess of $250 billion or foreign exposures of more than $10 billion. If activated by the agencies during the expansionary stage of a credit cycle, it could increase the minimum CET1 buffer by as much as another 2.5 percent of risk-weighted assets. The intent of the countercyclical capital buffer is to increase capital requirements during periods of rapid economic growth to reduce the excesses in lending and to protect against the effects of weakened underwriting standards during subsequent contractions.

A separate surcharge on systemically important banks (the so-called "SIFI surcharge"), which is to be the subject of a separate rulemaking, could potentially add another 3.5 percent of risk-weighted assets to the risk-based capital requirements of the largest banks. The cumulative effect of the countercyclical buffer and the potential SIFI requirement is that during an upswing in the credit cycle, some large U.S. banks may be required to hold CET1 equal to as much as 13 percent of their risk-weighted assets. This difference in potential capital requirements – i.e., as much as 13 percent for large banks compared with 7 percent for small banks – is intended to appropriately distinguish between their relative riskiness.

In addition to risk-based capital standards, all U.S. financial institutions are subject to a leverage ratio that is designed to limit the overall amount that a bank can leverage its capital. In this regard, another way in which the proposals differentiate between banks of different sizes is the new supplementary leverage ratio introduced in the Basel III NPR. This ratio would be set at 3 percent of adjusted assets and would apply only to large internationally active banks. It is a more demanding standard than the existing 4 percent leverage requirement that already applies to all banks because it would include certain off-balance-sheet exposures. If this proposed change is implemented, small banks would be subject to only one leverage ratio requirement whereas large banks would have to meet two requirements.

While the Basel III NPR focuses on raising the quality and quantity of capital, the Standardized Approach NPR seeks to ensure that riskier activities require more capital. To accomplish this, the Standardized Approach NPR would revise the capital treatment for exposures to non-U.S. sovereigns, residential mortgages, commercial real estate, securitizations, and equities, and revise and expand the recognition of credit risk mitigation through collateral and guarantees. It also would introduce new disclosure requirements for banks over $50 billion in assets, as a means to impose additional market discipline. This disclosure requirement would not apply to community banks. Finally, the Standardized Approach NPR would remove external credit ratings from the capital standards in accordance with section 939A of the Dodd-Frank Act.

The Advanced Approaches NPR applies only to the largest, internationally active banks. This NPR includes several changes to the calculation of risk-weighted assets for counterparty

exposures so that sufficient capital will be required for this source of risk that was found to be significant during the recent financial crisis.

In developing the June proposals, we were keenly aware of their potential impact, particularly on smaller banks throughout the country. The proposals include lengthy transition provisions and delayed effective dates to reduce the likelihood of adverse effects from increases in minimum required regulatory capital. For example, the revised risk weights included in the Standardized Approach NPR would not go into effect until 2015, and some of the transitional provisions related to capital instruments in the Basel III NPR extend out to 2022.

We assessed the potential effects of the proposed rules on banks by using regulatory reporting data and certain key assumptions, which we noted in the preamble to the proposals.[3] Our assessments indicate that many community banks hold capital well above both the existing and the proposed regulatory minimums. Many of the largest, internationally active banks already have strengthened their regulatory capital levels to meet the proposed minimum standards, particularly the new CET1 standard, in order to meet market participants' expectations. Establishing higher minimum standards for all banks would reinforce the financial strength of the banking sector in the future and the stability of the U.S. financial system.

While we did consider the potential impact of the proposals on banks and the banking system as we were developing them, one of the key purposes of the notice and comment process is to gain a better understanding of the potential impact of the proposals on banks of all sizes. As previously noted, to foster feedback from community banks on potential effects of the proposals, the agencies developed and posted on their respective Web sites an estimator tool that allowed smaller banks to use bank-specific information to assess the likely impact on their individual institution.

[3] See the attached impact assessment on OCC-regulated banks and thrifts pursuant to the Unfunded Mandates Reform Act.

Issues Raised in Comment Letters

1. Complexity and Applicability

Commenters have raised an overarching concern about the complexity of the rules. More specifically, many comments have stated that the residential mortgage provisions in the Standardized Approach NPR are too complex. The NPR would separate mortgages into two risk categories based on product and underwriting characteristics and then, within each category, assign several new risk weights based on loan-to-value ratios (LTVs). Commenters were concerned about the costs associated with reviewing the existing book of mortgages and creating new systems to accommodate the more granular treatment of risks under the proposed approach. Under today's standards, all mortgages are assigned just one of two weights based on criteria that are relatively simple to administer.

Commenters also raised concerns about complexities resulting from these capital proposals in combination with other regulatory initiatives. For example, banks of all sizes have raised concerns about the interactions between some of the provisions of the proposals and certain aspects of the Dodd-Frank Act. In particular, some commenters raised concerns about the interplay and overall effect that the proposed treatment for residential mortgages will have on the housing sector and availability of mortgage loans when combined with the pending regulations related to the definitions of "qualified mortgage" (QM) and "qualified residential mortgage" (QRM).[4] In developing the treatment for residential mortgages, the agencies were mindful of the proposed definitions of QM and QRM and specifically requested comment on whether mortgages that meet the QM definition should be included in the lower risk category of residential mortgage.

Some commenters suggested that, given the complexity of the proposals, the best way to reduce regulatory burden on community banks would be to delay the implementation of the

[4] Proposed regulations relate to the definition of "qualified mortgage" under regulations to be issued by the Consumer Financial Protection Bureau pursuant to the Truth in Lending Act (as revised by section 1412 of the Dodd-Frank Act), as well as the definition of "qualified residential mortgage" under the securitization risk retention regulations to be issued jointly by the federal banking agencies, FHFA, SEC, and HUD pursuant to section 941 of the Dodd-Frank Act.

Standardized Approach NPR or to exempt community banks altogether from any new capital rules. In this vein, many commenters observed that community banks did not cause the crisis, and therefore should be exempted. We will carefully consider these comments as well as suggestions for improving the NPR.

As noted earlier, we have taken steps to try to ease the burden of understanding the proposed set of rules for community banks. Nevertheless, we recognize that understanding and complying with the proposed rules could still be difficult for community banks. However, it is also important to recognize that the proposed rules are lengthy, in part, because they address banks of all shapes and sizes including banks involved in complex or risky activities, instruments, or lines of business. Banks engaged in these activities are not necessarily only the largest banks in the country but also can include smaller banks that engage in one or two complex or riskier activities. The proposed rules are comprehensive in their coverage and would therefore address such instances. The vast majority of community banks, however, will not need to consider many of these provisions.

Finally, it is important to remember that over 460 smaller banks have failed in the aftermath of the financial crisis for a variety of reasons but, ultimately, because they did not have enough capital in relation to the risks that they took. The future safety and soundness of community banks will depend on their having sufficient capital going forward.

2. Unrealized Losses

Another major issue raised by commenters is the inclusion of unrealized losses (and gains) on available-for-sale (AFS) debt securities in regulatory capital. Under our existing standards, such unrealized losses generally do not affect a bank's regulatory capital.[5] In contrast,

[5] Under the existing standards for national banks in 12 CFR Part 3, Appendix A, section 2, and for federal savings associations in 12 CFR 167.5, Tier 1 capital (national banks) and core capital (federal savings associations) include "common stockholders' equity." The definition of "common stockholders' equity" (listed at 12 CFR Part 3, Appendix A, section 1 for national banks and 12 CFR 167.1 for federal savings associations) does not include unrealized gains or losses on AFS debt securities, but it does include unrealized losses on AFS equity securities with readily determinable fair values. Additionally, at 12 CFR Part 3, Appendix A, section 2(b)(5) (national banks) and 12 CFR 167.5(b)(5) (federal savings associations), the current rules also provide that up to 45 percent of pretax net unrealized gains on AFS equity securities can be included in Tier 2 capital.

under the Basel III NPR, unrealized losses on AFS debt securities would directly impact a bank's regulatory capital.[6] The rationale for the proposal is that ignoring unrealized losses has the potential to mask the true financial position of a bank. This is particularly true when a bank is under stress and when creditors are most likely to be concerned about unrealized losses that could inhibit a bank's ability to meet its obligations.

Many bankers have commented that the inclusion of unrealized gains and losses on AFS debt securities could result in large and volatile changes in capital levels and other measures tied to regulatory capital, such as legal lending limits, especially when interest rates rise from the current low levels. Because these gains and losses often result from changes in interest rates rather than changes in credit risk, commenters also noted that the value of these assets on any particular day might not be a good indicator of the value of a security to a bank, given that the bank could hold the security until its maturity and realize the amount due in full (assuming no credit related issues).

There are strategies available to banks to minimize some of these potential adverse effects on regulatory capital. Banks could increase their capital, hedge or reduce the maturities of their AFS securities, or shift securities into the held-to-maturity portfolio at the cost of reducing liquidity. However, commenters have stated that these strategies are all expensive and some strategies, such as hedging or raising additional capital, may be especially expensive and difficult for community banks. Commenters also have noted that under the proposed approach,

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12 CFR Part 3, Appendix A, section 2(b)(5) (national banks) and 12 CFR 167.5(b)(5) (federal savings associations), further provide that unrealized gains and losses on other assets, including AFS debt securities, may be taken into account when considering a bank's overall capital adequacy, however, those gains and losses are not specifically included in the determination of a bank's regulatory capital ratios.

[6] Section 20(a)(1) of the proposal defines the elements that make up common equity tier 1 capital. Those elements include accumulated other comprehensive income (AOCI). Under U.S. GAAP, AOCI is comprised of four elements: (1) unrealized gains and losses on AFS securities (ASC Topic 320, Investments—Debt and Equity Securities); (2) gains and losses on derivatives held as effective cash flow hedges (ASC Topic 815, Derivatives and Hedging); (3) recognized actuarial gains and losses on defined benefit plans (ASC Topic 715, Compensation—Retirement Benefits); and (4) gains and losses resulting from currency translation of foreign subsidiaries financial statements (ASC Topic 830, Foreign Currency Matters). Under the existing capital standards, items one through three of AOCI are not included in regulatory capital.

offsetting changes in the value of other items on a bank's balance sheet would not be recognized for regulatory capital purposes when interest rates change. As a result, they stated that the proposed treatment could greatly overstate the real impact of interest rate changes on the safety and soundness of the bank.

The agencies anticipated many of the concerns raised by commenters on this issue and included a discussion within the Basel III NPR requesting comment on potentially excluding from regulatory capital unrealized gains and losses associated with U.S. Treasury and GSE debt that can be expected to be driven solely by interest rates. Under such an approach, other unrealized losses and gains -- for example, those associated with a corporate bond -- would be recognized in regulatory capital. The OCC recognizes the importance of this issue and the challenges the proposed treatment could present to banks, particularly community banks, in managing their capital, liquidity, and interest rate risk positions and in affecting their ability to lend to their communities. We are committed to reviewing this issue carefully.

3. Real Estate Lending

Another major concern of commenters relates to the proposed treatment for residential mortgages, and, to a lesser extent, commercial real estate. These provisions in the Standardized Approach NPR attempt to address some of the causes of the crisis – the collapse in residential mortgage underwriting standards and the prevalence of higher risk commercial real estate loans in some banks. Under our current rules, residential mortgages within a broad spectrum of risk attributes receive identical capital treatment. The treatment of commercial real estate loans is even less risk sensitive in that all such loans receive the same capital treatment. The proposed standard would raise the capital requirement for the riskiest mortgages and commercial real estate loans while actually lowering the charge on relatively safer residential mortgage loans.

Some of the major issues that commenters have raised relate to: the treatment of residential balloon mortgages; recordkeeping issues associated with the proposed use of LTV ratios; the treatment of second liens and commercial real estate; and the potential impact on the housing market. With respect to residential balloon mortgages, the concentration of credit risk in

the final balloon payment presents more risk to the lender than a loan that is fully amortized over a number of years – especially in situations where housing prices are not increasing. Therefore, the NPR proposes a relatively high capital charge.[7] Many community bankers have questioned this assumption and noted their good experience with balloons and their wide use in managing interest rate risk and providing credit to established customers.

On the recordkeeping that would be required for LTVs, while higher LTV ratios are closely associated with higher risks of default, many community bankers have stated that going back through their existing portfolios to determine each loan's LTV at origination would be a burdensome task. For this reason, some have suggested applying the proposed treatment prospectively.

Commenters have also raised concerns with the proposed treatments for second lien residential mortgages, such as home equity loans, and for certain commercial real estate loans. Similar to issues raised with balloon mortgages, commenters have expressed concern that the proposed rules do not adequately distinguish between prudent and more risky lending in such products.

With respect to broader implications for the housing market, while the proposal would actually lower capital requirements for the safest mortgages, it would also raise capital requirements for riskier mortgages, which could raise the incremental costs of such mortgages. Commenters have raised concerns about the impact this might have on recovery of the housing sector.

The OCC will pay attention to the unique and intimate knowledge that community banks possess of their customers and their lending relationships as we review the range of issues raised by commenters on our proposed treatment of real estate lending.

[7] Under the proposals, balloon mortgages would receive risk weights between 100 and 200 percent, depending on the loan's LTV.

Conclusion

Given the attention that the regulatory capital proposals have received recently, let me conclude by taking a moment to put these proposals in a broader perspective. Specifically, regulatory capital standards are an important component in a larger and more comprehensive process of bank supervision. They cannot and should not be viewed as a substitute for other assessments of a bank's financial position, including banks' internal capital adequacy assessments. They should be viewed as complementary to strong supervision of institutions, which requires in-depth and bank-specific analysis.

With this as the context, I want to reemphasize that we are still in the process of reviewing the many comment letters that we have received. We will carefully assess the advantages and disadvantages of the alternatives suggested, including assessing regulatory burden against the value of more and better quality capital that is better aligned to actual risks. As the Comptroller said last month, "As we finalize the rules, we will be thinking broadly about ways to reduce regulatory burden. As well as considering the substance of each provision, we will be taking a fresh look at the possible scope for transition arrangements, including the potential for grandfathering, to evaluate what we can do to lighten burden without compromising our two key principles of raising the quantity and quality of capital and setting minimum standards that generally require more capital for more risk."[8]

Given the vital role that banks serve in our national economy and local communities, we are committed to helping ensure that the business model of banks, both large and small, remains vibrant and viable. But, as a foundation for their future success, their capital has to stay strong too. If we can help ensure that, then we will be well along the road in ensuring that there is a stable and competitive banking system meeting household and business credit needs across America in the years ahead.

[8] Remarks by Thomas J. Curry, Comptroller of the Currency, before the American Bankers Association in San Diego, California, October 15, 2012.

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Carl Kaminski, Legislative and Regulatory Activities

Thru: Gary Whalen, Director, Policy Analysis Division

From: Douglas Robertson, Senior Financial Economist, Policy Analysis Division

Date: May 30, 2012

Subject: Impact Assessment for the Basel III Rule: General Capital Rules, NPR1

This memorandum provides our assessment of the economic impact of the proposed rules that would implement the Basel III framework developed by the Basel committee on Banking Supervision. The Basel III framework would revise current general risk-based capital rules and would be applicable to all banking organizations. The federal banking agencies are implementing Basel III through three separate rules. The first rule would apply Basel III minimum capital requirements to all banking organizations (NPR1). The second rule would implement new alternative measures of creditworthiness for general banking organizations (NPR2). The third rule would apply Basel III enhancements to institutions subject to the advanced approaches capital rules (NPR3). Advanced approaches banking organizations are those institutions with total assets of at least $250 billion or foreign exposures of at least $10 billion, or institutions that have elected to adopt the advanced approaches.

1) Basel III NPR (NPR1)
This will include the changes to the numerator of the risk-based capital ratio, the new ratio requirements (common equity Tier 1 and the higher minimums), as well as the conservation and countercyclical buffers. It also will include the changes to the treatment of mortgage servicing assets and deferred tax assets (DTAs).

2) Standardized Approach NPR (NPR2)
This will include the changes to the calculation of risk-weighted assets (the denominator of the risk-based capital ratio), except for the treatment of mortgage servicing assets and DTAs discussed in the Basel III NPR).

3) Advanced Approaches NPR (NPR3)
The advanced approaches NPR will introduce enhancements to the advanced approaches rule, and it will include a proposal to expand the scope of the market risk rule to include thrifts.

We estimate that the first-year cost associated with higher minimum capital requirements in NPR1 will be approximately $5.1 million. We estimate that the first-year cost associated with changes in risk-weighted assets and implementation of alternative measures of creditworthiness in NPR2 will be approximately $93.2 million. We estimate that the first-year cost associated with changes in risk-weighted assets and simultaneously meeting new market risk capital requirements in NPR3 will be approximately $46.8 million. Together, we estimate that the overall cost of the three Basel III rules will be approximately $145.1 million in the first year. After introducing new systems for determining risk weighted assets in the first year, we estimate that the overall cost of Basel III in subsequent years will decrease to approximately $98.6 million per year.

I. The Proposed Rule: Minimum Regulatory Capital Ratios (NPR1)

The proposed rule would implement Basel III and has the following major elements. The proposed rule would:

1. Introduce a new common equity Tier 1 capital ratio
2. Introduce a higher minimum Tier 1 capital ratio
3. Introduce a supplementary leverage ratio for advanced approaches banks
4. Introduce new capital conservation buffer
5. Introduce a countercyclical capital buffer for advanced approaches banks
6. Prompt Corrective Action thresholds: Introduce common equity Tier 1 thresholds and increase Tier 1 thresholds
7. Apply the proposed capital rules to savings and loan holding companies on a consolidated basis

The proposed rule also contains a reservation of authority that authorizes a banking organization's primary federal supervisor to require the banking organization to hold additional capital relative to what would be required under the proposed rule.

Section 1. Minimum Capital Requirements

Under the proposed rule, changes to minimum capital requirements include a new common equity Tier 1 capital ratio, a higher minimum Tier 1 capital ratio, a supplemental leverage ratio for advanced approaches banks, new thresholds for prompt corrective action purposes, a new capital conservation buffer, and a new countercyclical capital buffer for advanced approaches banks. All banking organizations would transition to the new minimum capital requirements between January 1, 2013, and January 1, 2019. Table 1 shows the transition table for minimum capital requirements under the proposed rule.

Although the proposed rule would also increase several prompt corrective action (PCA) thresholds, with the exception of the leverage ratio, the minimum capital conservation buffer in the proposal effectively requires all banking organizations in the United States to be well capitalized for PCA purposes by 2019. Adding the capital conservation buffer to minimum required capital ratios elevates the capital ratios above PCA well-capitalized thresholds beginning January 1, 2019.

Table 1.- Transition Schedule for Minimum Capital Requirements

	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019	PCA	
								Adq.	Well
Common Equity to Risk-Weighted Assets	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	6.5%
Tier 1 to Risk-Weighted Assets	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%	6%	8%
Total Capital to Risk-Weighted Assets	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8%	10%
Conservation Buffer to Risk-Weighted Assets				0.625%	1.25%	1.875%	2.5%		
Maximum Advanced Approaches Countercyclical Buffer				0.625%	1.25%	1.875%	2.5%		
Minimum Common Equity + Conservation Buffer	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%		
Minimum Tier 1 + Conservation Buffer	4.5%	5.5%	6.0%	6.625%	7.25%	7.875%	8.5%		
Minimum Total Capital + Conservation Buffer	8.0%	8.0%	8.0%	8.625%	9.125%	9.875%	10.5%		
Leverage Ratio	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4%	5%
Advanced Approaches Supplemental Leverage Ratio			Start to Report			3.0%	3.0%		

Section 2. Eligibility Requirements for Regulatory Capital Instruments

In addition to changing minimum required capital ratios, the proposed rule would also change what counts as capital. For instance, the proposed rule would increase deductions from regulatory capital for deferred tax assets, it would limit the inclusion of minority interests in capital, and unrealized gains and losses on all available-for-sale securities would flow through to common equity tier one capital.

A. Common Equity Tier 1 Capital Ratio

The proposed rule would require banking organizations to maintain a minimum 4.5 percent ratio of common equity Tier I capital to total risk-weighted assets. To be a well-capitalized institution under Prompt Corrective Action (PCA) regulations, banking organizations would need to maintain a minimum ratio of 6.5 percent.

Under the proposed rule, common equity Tier 1 capital would equal the sum of common stock and related surplus (net of any Treasury stock), retained earnings, accumulated other comprehensive income (AOCI), and common equity Tier 1 minority interest subject to limits minus regulatory adjustments and deductions. Qualifying common stock instruments would have to satisfy certain criteria. The banking agencies expect that the vast majority of existing common stock will fully satisfy these criteria.

New deductions from common equity Tier 1 capital include the following:

a. Mortgage Servicing Assets (MSAs)
b. Deferred tax assets (DTAs)
c. Investments in the capital of an unconsolidated financial institution above a threshold
d. Changes in accumulated other comprehensive income (AOCI) without adjustments for gains and losses in available-for-sale debt securities
e. Investments in hedge funds and private equity funds consistent with the Volcker Rule[1]

B. Tier 1 Capital: Additional Tier 1

Under the proposed rule, total Tier I capital would equal the sum of common equity Tier 1 capital and additional Tier 1 capital. Additional Tier 1 capital equals the sum of noncumulative perpetual preferred, related surplus, other Tier 1 minority interest, and various SBLF and EESA qualifying instruments less certain adjustments and deductions. Trust preferred securities would no longer be eligible for inclusion in Tier 1 capital. Additional Tier 1 capital instruments must also satisfy certain criteria. In essence, these instruments must be subordinated, have fully discretionary non-cumulative dividends, have no maturity date, have no incentives to redeem, and must be able to absorb losses. Instruments currently included in Tier 1 capital that do not meet the new criteria will be phased out of the Tier 1 regulatory capital calculation beginning in January 1, 2014 and will be 100 percent phased out beginning January 1, 2018, except for trust-preferred securities, which must be phased out according to a different timeline set forth in section 171 of the Dodd-Frank Act.

C. Tier 2 Capital

[1] This deduction is consistent with the proposed Volcker Rule. In our impact assessment for that rule, we estimated that banking organizations could invest in hedge funds and private equity funds up to as much as three percent of Tier 1 capital. As this deduction depends on the still pending final Volcker Rule, we defer assessment of the cost of this deduction until we conduct our economic impact analysis of the final Volcker Rule.

The proposed rule will also adjust Tier 2 capital elements. Tier 2 capital instruments must satisfy eligibility criteria as well. In particular, the instrument must have an original maturity of at least 5 years. Under the proposed rule, banking organizations may include limited amounts of common equity of a consolidated depository institution subsidiary.

D. Leverage Ratio

The proposed rule would require advanced approaches banks to maintain a three percent minimum Basel 3 leverage ratio in addition to the current U.S. leverage ratio. The Basel 3 leverage ratio is defined as a ratio of Tier 1 capital to a sum of on-balance sheet and certain off-balance sheet assets. The Basel 3 leverage ratio would supplement the current U.S. leverage ratio, which only includes on-balance sheet items in the ratio's denominator.

E. Capital Conservation and Countercyclical Buffers

The proposed rule would require all banking organizations to hold common equity Tier 1 capital in the form of a capital conservation buffer. The capital conservation buffer would begin to phase-in on January 1, 2016 and be fully phased-in at 2.5 percent of risk-weighted assets on January 1, 2019. Combined with other minimum capital requirements, the capital conservation buffer effectively requires banks to maintain a 7 percent common equity Tier 1 ratio, an 8.5 percent Tier 1 ratio, and a 10.5 percent total risk-based capital ratio.

The proposed rule would also require advanced approaches banking organizations to hold additional common equity Tier 1 capital in a countercyclical buffer, which would range between zero and 2.5 percent of risk-weighted assets. The countercyclical buffer would apply when the primary federal regulator determines (using various guide variables) that a period of excessive credit growth is contributing to an increase in systemic risk. The regulator would generally announce the level of the buffer 12 months in advance of its implementation, but may give shorter notice if necessary.

Institutions that do not meet the capital conservation buffer or the countercyclical capital buffer requirements would be subject to limitations on capital distributions and incentive compensation payments proportional to the shortfall in the buffer. A banking organization that operates in multiple jurisdictions would have to calculate its countercyclical capital buffer as the weighted average of the countercyclical capital buffer for each jurisdiction.

II. Institutions Affected By the Proposed Rule

The proposed minimum capital requirements will apply to all banking organizations. According to December 31, 2011 Call Report data, there are 7,432 FDIC-insured institutions. After aggregating to the highest holding company, there are 6,744 bank holding companies, of which,

1,213 are national banking organizations.[2] Excluding several thrifts that are included as subsidiaries of national banking organizations, the proposed rule would also apply to 612 federally chartered private savings institutions. Thus, the proposed rule would apply to 1,825 financial institutions regulated by the OCC.

III. Estimated Costs and Benefits of the Proposed Rule

The various elements of the proposed rule will affect costs in three ways: (1) the cost of capital institutions will need to meet the higher minimum capital ratios and the new eligibility standards for capital, (2) compliance costs associated with establishing the infrastructure to determine correct risk weights using the new alternative measures of creditworthiness, and (3) compliance costs associated with new disclosure requirements. Some institutions will also incur costs associated with new capital requirements for exposures to central counterparties and changes to recognized collateral and eligible guarantors, but we subsume these expenses into our general cost of capital estimates. In this analysis of the proposed rule covering minimum capital requirements, we only estimate the cost of capital necessary to make up any projected shortfall between current capital levels and the proposed rule's new minimum capital requirements.

Benefits of the Proposed Rule

The proposed rule would produce the following benefits:

1. Improves the quality of regulatory capital by introducing a common equity Tier 1 regulatory capital requirement and tightening the standards for including non-common equity instruments in regulatory capital
2. Increases risk sensitivity of capital requirements and risk-weighted assets
3. Improves loss absorbency of regulatory capital
4. Improve transparency and market discipline through disclosure requirements.
5. Enhanced supervisory review process through the establishment of Pillar 2-based expectations for banking organizations
6. Enhances counterparty credit risk capital requirements that proved inadequate during the financial crisis

Costs of the Proposed Rule

To estimate the impact of the proposed rule on bank capital needs, we estimate the amount of capital banks will need to amass to meet the new minimum standards relative to the amount of capital they currently hold. To estimate new capital ratios and requirements, we use currently available data from banks' quarterly Consolidated Report of Condition and Income (Call Reports) to approximate capital under the proposed rule. We arrive at our estimates of the new numerators of the capital ratios by combining various Call Report items to reflect definitional changes to common equity capital, Tier 1 capital, and total capital as described in the proposed

[2] A national banking organization is any bank holding company with a subsidiary national bank. Two of the 16 organizations also include a federally chartered private savings institution, but both of these organizations also contain a national bank and are included in the 16 national banking organizations.

rule. The capital ratio denominator, risk-weighted assets, will also change under the proposed rule. However, because the idiosyncratic nature of each institution's asset portfolio will cause the direction and extent of the change in the denominator to vary from institution to institution, we are unable to estimate risk-weighted assets under the proposed rule. Instead, we use the current definition of risk-weighted assets and thus the amount reported by institutions in their most recent Call Report.

Using our estimates of the proposed capital ratio numerators and holding these capital levels constant through 2019, we estimate the capital shortfall each institution would encounter as the new capital ratios come into effect according to the schedule shown in table 1. Table 2 shows our estimates of the number of institutions that would not meet the transition schedule for minimum capital requirements using data as of December 31, 2011. Table 3 shows our estimates of the aggregate amount of capital shortfall over the transition period ending in 2019. While institutions must simultaneously meet all of the minimum capital requirements, the largest shortfall amount in any given year shows the most binding minimum capital requirement. The number of institutions and the capital shortfall amounts shown in the 2016 column reflect those institutions that show a shortfall with regard to the new PCA standards relative to current capital levels.

As shown in table 3, our estimate of the largest capital shortfall would be a $1,111 million shortfall in total capital plus the capital conservation buffer in 2019. However, a slightly smaller shortfall of $1,088 million arrives four years earlier when the new Tier 1 PCA standard for well-capitalized institutions takes effect on January 1, 2015. We view this new PCA Tier 1 standard as the earliest significant capital constraint in the proposed rule.

Because banks confronting a capital shortfall under the proposed rule will need to gradually increase their capital levels to meet the proposed transition schedule, the aggregate cost of increasing capital will be spread out over several years. We estimate that the largest shortfall for any given year will be approximately $900 million to meet the new PCA Tier 1 standard for well-capitalized institutions when it takes effect in 2015. This estimate combines the capital needs for national banking organizations and federally chartered private savings institutions (together, OCC institutions).

To estimate the cost to banks of the new capital requirement, we examine the effect of this requirement on capital structure and the overall cost of capital.[3] The cost of financing a bank or any firm is the weighted average cost of its various financing sources, which amounts to a weighted average cost of capital reflecting many different types of debt and equity financing. Because interest payments on debt are tax deductible, a more leveraged capital structure reduces corporate taxes, thereby lowering funding costs, and the weighted average cost of financing tends to decline as leverage increases. Thus, an increase in required equity capital would force a bank to deleverage and – all else equal – would increase the cost of capital for that bank.

[3] See Merton H. Miller, (1995), "Do the M & M propositions apply to banks?" *Journal of Banking & Finance*, Vol. 19, pp. 483-489.

This increased cost would be tax benefits foregone: the capital requirement ($900 million), multiplied by the interest rate on the debt displaced and by the effective marginal tax rate for the banks affected by the proposed rule. The effective marginal corporate tax rate is affected not only by the statutory federal and state rates, but also by the probability of positive earnings (since there is no tax benefit when earnings are negative), and for the offsetting effects of personal taxes on required bond yields. Graham (2000) considers these factors and estimates a median marginal tax benefit of $9.40 per $100 of interest. So, using an estimated interest rate on debt of 6 percent, we estimate that the annual tax benefits foregone on $900 million of capital switching from debt to equity is approximately $900 million * 0.06 (interest rate) * 0.094 (median marginal tax savings) = $5.1 million per year.[4]

The banking agencies will also incur some modest costs associated with macro-prudential monitoring. Under the proposed rule, the agencies would need to monitor credit growth through the use of various guide variables such as credit default swap spreads, funding spreads, and asset prices. We estimate that this macro-prudential monitoring will involve approximately 192 hours per year per agency. This estimate assumes that the monitoring and reporting will involve two individuals for eight hours a month (2 x 8 x 12 = 192). Applying our wage estimate of $85 per hour, we estimate that the total cost of macro-prudential monitoring and reporting will be approximately $48,960 per year for all three banking agencies ($85 x 192 x 3 = $48,960).

Our overall estimate for this segment of the Basel III proposal is $5.1 million per year.

[4] See John R. Graham, (2000), How Big Are the Tax Benefits of Debt?, *Journal of Finance*, Vol. 55, No. 5, pp. 1901-1941. Graham points out that ignoring the offsetting effects of personal taxes would increase the median marginal tax rate to $31.5 per $100 of interest.

Table 2. – Cumulative Number of OCC-Regulated Banking Organizations Short of the Transition Schedule for Minimum Capital Requirements, December 31, 2011

		Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	NBOs	5	8	12	13	25			
	FCPSIs	7	12	12	12	18			
	Total	12	20	24	25	43			
Tier 1 to Risk-Weighted Assets	NBOs	10	10	12	16	30			
	FCPSIs	10	11	13	16	21			
	Total	20	21	25	32	51			
Minimum Total Capital + Conservation Buffer	NBOs	22				27	27	31	39
	FCPSIs	17				18	22	27	28
	Total	39				45	49	58	67
Advanced Approaches Countercyclical Buffer	NBOs								0
	FCPSIs								0
	Total								0
Advanced Approaches Leverage Ratio	NBOs							0	
	FCPSIs							0	
	Total							0	

Table 3. – Capital Shortfall for Scheduled Minimum Capital Requirements, ($ in millions)
December 31, 2011

		Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	NBOs	$18	$42	$54	$67	$357			
	FCPSIs	$51	$83	$100	$117	$202			
	Total	$69	$125	$154	$184	$559			
Tier 1 to Risk-Weighted Assets	NBOs	$25	$32	$62	$79	$849			
	FCPSIs	$49	$62	$88	$110	$239			
	Total	$74	$94	$150	$189	$1,088			
Minimum Total Capital + Conservation Buffer	NBOs	$169				$271	$355	$498	$670
	FCPSIs	$152				$189	$228	$342	$441
	Total	$321				$460	$583	$840	$1,111
Advanced Approaches Countercyclical Buffer	NBOs								0
	FCPSIs								0
	Total								0
Advanced Approaches Leverage Ratio	NBOs							0	
	FCPSIs							0	
	Total							0	

Regulatory Flexibility Act (RFA) Analysis

As part of our analysis, we considered whether the proposed rule is likely to have a significant impact on a substantial number of small entities, pursuant to the RFA. The size threshold for small banks is $175 million. Tables 4 and 5 show our estimates of the number and capital shortfall for small institutions under the proposed rule. We estimate that the cost of lost tax benefits associated with increasing total capital by $82 million as shown in table 5 will be approximately $0.5 million per year. Averaged across the 28 affected institutions, the cost is approximately $18,000 per institution per year. Among the small institutions facing a potential capital shortfall over the transition period, this cost would only be significant for three of these institutions when measured against total noninterest expenses. Thus, we believe that this proposed rule will not have a significant impact on a substantial number of small entities.

Table 4. – Cumulative Number of Small OCC-Regulated Banking Organizations Short of the Transition Schedule for Minimum Capital Requirements, December 31, 2011

		Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	NBOs	4	6	8	9	12			
	FCPSIs	2	3	3	3	6			
	Total	6	9	11	12	18			
Tier 1 to Risk-Weighted Assets	NBOs	7	7	8	10	14			
	FCPSIs	2	3	3	4	6			
	Total	9	10	11	14	20			
Minimum Total Capital + Conservation Buffer	NBOs	11				14	14	15	19
	FCPSIs	4				4	5	9	9
	Total	15				18	19	24	28

Table 5. – Capital Shortfall for Small OCC-Regulated Banking Organizations for Scheduled Minimum Capital Requirements, ($ in millions) December 31, 2011

		Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	NBOs	$9	$17	$20	$23	$39			
	FCPSIs	$1	$2	$2	$2	$5			
	Total	$10	$19	$22	$25	$44			
Tier 1 to Risk-Weighted Assets	NBOs	$21	$24	$30	$33	$54			
	FCPSIs	$1	$1	$2	$2	$8			
	Total	$22	$25	$32	$35	$62			
Minimum Total Capital + Conservation Buffer	NBOs	$40				$46	$52	$61	$69
	FCPSIs	$3				$5	$6	$10	$13
	Total	$43				$51	$58	$71	$82

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Carl Kaminski, Legislative and Regulatory Activities

Thru: Gary Whalen, Director, Policy Analysis Division

From: Douglas Robertson, Senior Financial Economist, Policy Analysis Division

Date: May 30, 2012

Subject: Impact Assessment for Basel III: Standardized Approaches to Risk-weighted Assets, NPR2

This memorandum provides our assessment of the economic impact of the proposed rules that would implement the Basel III framework developed by the Basel Committee on Banking Supervision. The Basel III framework would revise current general risk-based capital rules and would be applicable to all banking organizations. The federal banking agencies are implementing Basel III through three separate rules. The first rule would apply Basel III minimum capital requirements to all banking organizations (NPR1). The second rule would implement new alternative measures of creditworthiness for all banking organizations (NPR2).[1] The third rule would apply Basel III enhancements to the risk-weighted assets of institutions subject to the advanced approaches capital rules (NPR3).

1) Basel III NPR (NPR1)
This will include the changes to the numerator of the risk-based capital ratio, the new ratio requirements (common equity Tier 1 and the higher minimums), as well as the conservation and countercyclical buffers. It also will include the changes to the treatment of mortgage servicing assets and deferred tax assets (DTAs).

2) Standardized Approach NPR (NPR2)
This will include the changes to the calculation of risk-weighted assets (the denominator of the risk-based capital ratio), except for the treatment of mortgage servicing assets and DTAs discussed in the Basel III NPR.
3) Advanced Approaches NPR (NPR3)
The advanced approaches NPR will introduce enhancements to the advanced approaches rule, and it will include a proposal to expand the scope of the market risk rule to include thrifts.

[1] These rules would serve as the generally applicable capital rules and therefore would be a floor for the risk-based capital requirement for advanced approaches banks under Section 171 of the Dodd Frank Act.

We estimate that the first-year cost associated with higher minimum capital requirements in NPR1 will be approximately $5.1 million. We estimate that the first-year cost associated with changes in risk-weighted assets and implementation of alternative measures of creditworthiness in NPR2 will be approximately $93.2 million. We estimate that the first-year cost associated with changes in risk-weighted assets and simultaneously meeting new market risk capital requirements in NPR3 will be approximately $46.8 million. Together, we estimate that the overall cost of the three Basel III rules will be approximately $145.1 million in the first year. After introducing new systems for determining risk weighted assets in the first year, we estimate that the overall cost of Basel III in subsequent years will decrease to approximately $98.6 million per year.

I. The Proposed Rule: Standardized Approach for Risk-weighted Assets (NPR2)

The proposed rule (NPR 2) includes changes to the general risk-based capital requirements that address the calculation of risk-weighted assets. The proposed rule would:

1. Revise the treatment of 1-4 family residential mortgages
2. Introduces a higher risk weight for certain past due exposures and acquisition and development real estate loans
3. Provides a more risk sensitive approach to exposures to non- U.S. sovereigns and non-U.S. public sector entities
4. Replace references to credit ratings with alternative measures of creditworthiness
5. Provides more comprehensive recognition of collateral and guarantees
6. Provides a more favorable capital treatment for transactions cleared through qualifying central counterparties
7. Introduces disclosure requirements for banking organizations with assets of $50 billion or more

Calculating Risk-Weighted Assets

Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires federal agencies to remove references to credit ratings from regulations and replace credit ratings with appropriate alternatives. The proposed rule would introduce alternative measures of creditworthiness for securitization positions and re-securitization positions. Table 1 summarizes changes in the proposed rule.

Table 1: Key Provisions of the Proposed Rule for Calculating Risk-weighted Assets

Aspect of Proposed Rule	Proposed Treatment
Risk-weighted Assets	
Credit exposures to: U.S. government and its agencies U.S. government-sponsored entities U.S. depository institutions and credit unions U.S. public sector entities, such as states and municipalities	Unchanged.
Credit exposures to: Foreign sovereigns Foreign banks Foreign public sector entities	Introduces a more risk-sensitive treatment using the Country Risk Classification measure produced by the Organization for Economic Cooperation and Development.
Corporate exposures	Assigns a 100 percent risk weight to corporate exposures, including exposures to securities firms.
Residential mortgage exposures	Introduces a more risk-sensitive treatment based on several criteria, including the loan-to-value-ratio of the exposure.
High volatility commercial real estate exposures	Applies a 150 percent risk weight to certain credit facilities that finance the acquisition, development or construction of real property.
Past due exposures	Applies a 150 percent risk weight to exposures that are not sovereign exposures or residential mortgage exposures and that are more than 90 days past due or on nonaccrual.
Securitization exposures	Maintains the gross-up approach for securitization exposures. Replaces the current ratings-based approach with a formula-based approach for determining a securitization exposure's risk weight based on the underlying assets and exposure's relative position in the securitization's structure.
Equity exposures	Introduces more risk-sensitive treatment for equity exposures.
Off-balance Sheet Items	Revises the measure of the counterparty credit risk of repo-style transactions. Raises the credit conversion factor for most short-term commitments from zero percent to 20 percent.
Derivative Contracts	Removes the 50 percent risk weight cap for

Aspect of Proposed Rule	Proposed Treatment
	derivative contracts.
Cleared Transactions	Provides preferential capital requirements for cleared derivative and repo-style transactions (as compared to requirements for non-cleared transactions) with central counterparties that meet specified standards. Also requires that a clearing member of a central counterparty calculate a capital requirement for its default fund contributions to that central counterparty.
Credit Risk Mitigation	Provides a more comprehensive recognition of collateral and guarantees.
Disclosure Requirements	Introduces qualitative and quantitative disclosure requirements, including regarding regulatory capital instruments, for banking organizations with total consolidated assets of $50 billion or more that are not subject to the separate advanced approaches disclosure requirements.

Alternative Measure for Securitization Positions

The alternative measure for securitization positions is a simplified version of the Basel II advanced approaches supervisory formula approach. The simplified supervisory formula approach (SSFA) applies a 100 percent risk-weighting factor to the junior most portion of a securitization structure equal to the amount of capital a bank would have to hold if it retained the entire pool on its balance sheet. For the remaining portions of the securitization pool, the SSFA uses an exponential decay function to assign a marginal capital charge per dollar of a tranche. Securitization positions for which a bank does not use the SSFA would be subject to a 100 percent risk-weighting factor. The proposed rule would also apply minimum risk weights to securitization tranches that would increase as cumulative losses to the pool increase. The proposed rule would allow institutions other than advanced approaches banking organizations to use the gross-up approach, which is similar to an approach provided for under current risk-based capital rules.

Alternative Measure for Exposures to Sovereign Entities

The proposed rule would assign capital requirements to sovereign exposures based on OECD Country Risk Classifications (CRCs). Risk weights would range from zero percent to 150 percent based on CRCs, and sovereigns that have defaulted on any exposure during the previous five years would have a 150 percent risk weight. Default would include a restructure that results in a sovereign entity not servicing an obligation according to its terms prior to the restructuring.

Exposures to the United States government and its agencies would always carry a zero percent risk weight. Sovereign entities that have no CRC would carry a 100 percent risk weight.

The proposed rule would apply a zero percent risk weight to exposures to supranational entities and multilateral development banks. International organizations that would receive a zero percent risk weight include the Bank for International Settlements, the European Central Bank, the European Commission, and the International Monetary Fund. The proposed rule would also apply a zero percent risk weight to exposures to 13 named multilateral development banks and any multilateral lending institution or regional development bank in which the U.S. government is a shareholder or member, or if the bank's primary federal supervisor determines that the entity poses comparable credit risk.

Other Positions

Corporate Exposures: The proposed rule would maintain current practice under general risk-based capital rules and assign a 100 percent risk weight to all corporate exposures.

Government Sponsored Entities (GSEs): The proposal would apply a risk weight of 20 percent to non-equity exposures and a 100 percent risk weight to preferred stock issued by a GSE.

Depository Institutions, Foreign Banks, and Credit Unions: Generally, the proposal would link depository institution risk weights to the sovereign entity risk weight. Under the proposal, sovereign entity risk weights may take one of the following percentage values: (0, 20, 50, 100, 150). Generally, exposures to foreign depository institutions would receive a risk weight one category higher than the risk weight assigned to the home sovereign. For instance, a bank based in a country that carries a zero percent risk weight would carry a 20 percent risk weight. If a country does not have a CRC, a bank based in that country also carries a 100 percent risk weight. Banks in countries with 150 percent risk weights would also carry 150 percent risk weights.

Residential Mortgage Exposures: The proposed rule would maintain the current risk-based capital treatment for residential mortgage exposures that are guaranteed by the U.S. government or its agency. Residential mortgage exposures that are unconditionally guaranteed by the U.S. government or a U.S. agency would receive a zero percent risk weight, and residential mortgage exposures that are conditionally guaranteed by the U.S. government or a U.S. agency would receive a 20 percent risk weight. A banking organization would divide other residential mortgages into one of two categories based on various loan characteristics such as duration, amortization, performance, and underwriting standards. These loans would then receive risk weights based on the loan-to-value ratio at the origination of the loan or at the time of restructuring. Table 2 shows the risk weights for residential mortgages.

Table 2 – Risk Weights for Residential Mortgage Exposures

Loan-to-value ratio (in percent)	Category 1 residential mortgage exposure (in percent)	Category 2 residential mortgage exposure (in percent)
Less than or equal to 60	35	100
Greater than 60 and less than or equal to 80	50	100
Greater than 80 and less than or equal to 90	75	150
Greater than 90	100	200

High Volatility Commercial Real Estate Exposures: The proposed rule would assign a 150 percent risk weight to any high volatility commercial real estate exposure. The proposed rule would generally define such an exposure as a loan that finances the acquisition, development, or construction of real property that is not a one- to four-family residential property or certain commercial real estate projects.

Public Sector Entities (PSEs): A PSE is a state, local authority, or other governmental subdivision below the level of a sovereign entity. The proposed rule would apply the same risk weights to exposures for U.S. states and municipalities as current general risk-based capital rules. Under the proposal, a banking organization would assign a 20 percent risk weight to a general obligation exposure to a U.S. PSE and a 50 percent risk weight to a revenue obligation exposure to such a PSE. For non-U.S. PSEs, the proposed rule would assign a risk weights based on the sovereign's CRC. One risk weight schedule would apply to general obligation claims and another schedule would apply to revenue obligations. Table 3 shows the risk-weight linkage for sovereigns and non-U.S. PSEs.

Table 3. Risk Weights for Exposures to Sovereigns and Public Sector Entities

Sovereign CRC	Sovereign Entity Risk Weights (in percent)	Non-U.S. PSE General Obligation Claim Risk Weights (in percent)	Non-U.S. PSE Revenue Obligation Risk Weights (in percent)
0-1	0	20	50
2	20	50	100
3	50	100	100
4-6	100	150	150
7	150	150	150
No CRC	100	100	100
Sovereign Default	150	150	150

Disclosure Requirements

The proposed rule would also introduce new disclosure requirements for banking organizations with $50 billion or more in total assets. The proposed rule would also introduce a Pillar 2 supervisory review process for all banking organizations.

II. Institutions Affected By the Proposed Rule

According to December 31, 2011 Call Report data, there are 7,432 FDIC-insured institutions. After aggregating to the highest holding company, there are 6,744 bank holding companies, of which, 1,213 are national banking organizations.[2] Excluding several thrifts that are included as subsidiaries of national banking organizations, the proposed rule would also apply to 612 federally chartered private savings institutions. Thus, the proposed rule would apply to 1,825 financial institutions regulated by the OCC. Banking organizations using the advanced approaches would not be affected by major portions of the proposed rule.

III. Estimated Costs and Benefits of the Proposed Rule

The various elements of the proposed rule will affect costs in three ways: (1) the cost of capital institutions will need to meet the higher minimum capital ratios and the new eligibility standards for capital, (2) compliance costs associated with establishing the infrastructure to determine correct risk weights using the new alternative measures of creditworthiness, and (3) compliance costs associated with new disclosure requirements.

Benefits of the Proposed Rule

The proposed rule would produce the following benefits:

1. Improves the quality of regulatory capital by introducing a common equity Tier 1 regulatory capital requirement and tightening the standards for including non-common equity instruments in regulatory capital
2. Increases risk sensitivity of capital requirements and risk-weighted assets
3. Improves loss absorbency of regulatory capital
4. Improve transparency and market discipline through disclosure requirements.
5. Expanded list of eligible third-party guarantors (page 143)
6. Expanded array of collateral types
7. Enhanced supervisory review process through the establishment of Pillar 2-based expectations for banking organizations
8. Enhances counterparty credit risk capital requirements that proved inadequate during the financial crisis

[2] A national banking organization is any bank holding company with a subsidiary national bank. Two of the 16 organizations also include a federally chartered private savings institution, but both of these organizations also contain a national bank and are included in the 16 national banking organizations.

Costs of the Proposed Rule

1. Impact of Risk-weighted Assets on Capital Requirements

Minimum required capital levels are likely to change under the proposed rule. The increased risk sensitivity of the alternative measures of creditworthiness implies that capital requirements may go down for some assets and up for others. For those assets with a higher capital charge under the proposed rule, however, that increase may be large in some instances, e.g., requiring a dollar-for-dollar capital charge for some securitization exposures.

The Basel Committee on Banking Supervision has been conducting periodic reviews of the potential quantitative impact of the Basel III framework. The quantitative impact study working group reported that the average change in risk-weighted assets for a global sample of larger banks (including some U.S. banks) was approximately 20 percent.[3] Although these reviews monitor the impact of implementing the Basel III framework rather than the provisions of the proposed rule, for the purposes of this analysis we consider the results of the Basel working group to be a best estimate and thus we increase risk-weighted assets by 20 percent to estimate the impact of the proposed rule on risk-weighted assets.

To estimate the impact of the proposed rule on bank capital needs, we estimate the amount of capital banks will need to amass to meet the new minimum standards described in our analysis of NPR1. As with that analysis, we estimate new capital ratios and requirements by combining various Call Report items to reflect definitional changes to common equity capital, Tier 1 capital, and total capital as described in NPR1. Because this proposed rule, NPR2, will change the capital ratio denominator, risk-weighted assets, we increase current risk-weighted assets by 20 percent. We use this 20 percent adjustment while recognizing that the idiosyncratic nature of each institution's asset portfolio will undoubtedly cause the direction and extent of the change in the denominator to vary considerably from institution to institution.

We thus construct new capital ratios reflecting the requirements of the proposed rules (NPR1 and NPR2) and estimate capital shortfalls as the difference between current capital levels and capital levels necessary to meet the new minimum standards. We estimate the capital shortfall each institution would encounter as the new capital ratios come into effect during the transition period from 2013 through 2019. Table 4 shows our estimates of the number of institutions that would not meet the transition schedule for proposed minimum capital requirements using data as of December 31, 2011. Table 5 shows our estimates of the aggregate amount of capital shortfall over the transition period ending in 2019. While institutions must simultaneously meet all of the minimum capital requirements, the largest shortfall amount in any given year shows the most binding minimum capital requirement. The number of institutions and the capital shortfall amounts shown in the 2016 column reflect those institutions that show a shortfall with regard to the new PCA standards relative to current capital levels.

[3] The working group also reported an average change in risk-weighted assets for a global sample of smaller banks (those with Tier 1 capital less than €3 billion), but no U.S. banks participated in this sample. The reported average increase for this group was less than 10 percent, which suggests that our use of a 20 percent increase in risk-weighted assets for all institutions may overestimate the impact of the proposed rule.

As shown in table 4, our estimate of the largest capital shortfall would be an approximately $27 billion shortfall in 2015 when the new Tier 1 PCA standard for well-capitalized institutions takes effect. We view this new PCA Tier 1 standard as the major capital constraint in the proposed rule.

Because banks confronting a capital shortfall under the proposed rule will need to at least increase their capital levels gradually to meet the transition schedule, we assume that the aggregate cost of increasing capital will be spread out over several years. We estimate that the largest shortfall for any given year will be approximately $9.0 billion, or one third of the amount needed to meet the new PCA Tier 1 standard for well-capitalized institutions when it takes effect. This estimate combines the capital needs for national banking organizations and federally chartered private savings institutions (together, OCC institutions).

To estimate the cost to banks of the new capital requirement, we examine the effect of this requirement on capital structure and the overall cost of capital.[4] As with our estimate in NPR1, we estimate that the cost of the increase in capital would be tax benefits foregone: the capital requirement ($9.0 billion), multiplied by the interest rate on the debt displaced and by the effective marginal tax rate for the banks affected by the proposed rule. Graham (2000) estimates a median marginal tax benefit of $9.40 per $100 of interest. So, using an estimated interest rate on debt of 6 percent, we estimate that the annual tax benefits foregone on $9.0 billion of capital switching from debt to equity is approximately $9.0 billion * 0.06 (interest rate) * 0.094 (median marginal tax savings) = $50.8 million per year.[5] Approximately $5.1 million per year is attributable to NPR1, leaving $45.7 million per year as the capital cost of NPR2.

[4] See Merton H. Miller, (1995), "Do the M & M propositions apply to banks?" *Journal of Banking & Finance*, Vol. 19, pp. 483-489.

[5] See John R. Graham, (2000), "How Big Are the Tax Benefits of Debt?" *Journal of Finance,* Vol. 55, No. 5, pp. 1901-1941. Graham points out that ignoring the offsetting effects of personal taxes would increase the median marginal tax rate to $31.5 per $100 of interest.

Table 4. – Cumulative Number of OCC-Regulated Banking Organizations Short of the Transition Schedule for Minimum Capital Requirements and Estimated Risk-weighted Assets, December 31, 2011

		Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	NBOs	7	12	15	16	32			
	FCPSIs	8	12	12	14	22			
	Total	15	24	27	30	54			
Tier 1 to Risk-Weighted Assets	NBOs	11	12	22	26	53			
	FCPSIs	11	13	18	18	33			
	Total	22	25	40	44	86			
Minimum Total Capital + Conservation Buffer	NBOs	30				34	47	82	130
	FCPSIs	26				28	37	51	60
	Total	56				62	84	133	190
Advanced Approaches Countercyclical Buffer	NBOs								0
	FCPSIs								0
	Total								0
Advanced Approaches Leverage Ratio	NBOs							0	
	FCPSIs							0	
	Total							0	

Table 5. – Capital Shortfall for Scheduled Minimum Capital Requirements and Estimated Risk-weighted Assets, ($ in millions) December 31, 2011

		Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	NBOs	$17	$59	$96	$186	$924			
	FCPSIs	$51	$106	$127	$148	$288			
	Total	$68	$165	$223	$334	$1212			
Tier 1 to Risk-Weighted Assets	NBOs	$41	$59	$107	$142	$26,192			
	FCPSIs	$70	$85	$144	$180	$490			
	Total	$111	$144	$251	$322	$26,682			
Minimum Total Capital + Conservation Buffer	NBOs	$437				$623	$1,172	$5,755	$24,630
	FCPSIs	$300				$417	$531	$810	$1,122
	Total	$ 737				$1040	$1,703	$6,565	$25,752
Advanced Approaches Countercyclical Buffer	NBOs								0
	FCPSIs								0
	Total								0
Advanced Approaches Leverage Ratio	NBOs							0	
	FCPSIs							0	
	Total							0	

2. Alternative Measures of Creditworthiness

The proposed rule would require institutions to (1) establish systems to determine risk weights using the alternative measures of creditworthiness described in the proposal, and (2) apply these alternative measures to the bank's assets. We believe that this element of the proposed rule will involve costs associated with gathering and updating the information necessary to calculate the relevant risk weights, establishing procedures, and maintaining the programs that perform the calculations.

In particular, the proposed rule would require institutions with assets in each affected asset category to:

1. Establish and maintain a system to apply the gross-up approach or implement the simplified supervisory formula approach (SSFA) for securitization positions.
2. Establish and maintain a system to assign risk weights to sovereign exposures.
3. Establish and maintain systems to assign risk weights to non-U.S. public sector entities, depository institutions, and other foreign positions.
4. Assign 1-4 family residential mortgage exposures to one of two categories.

Listed below are the variables banks will need to gather to calculate risk weights under the proposed rule:

Securitization Positions:

1. Weighted average risk weight of assets in the securitized pool as determined under generally applicable risk-based capital rules
2. The attachment point of the relevant tranche
3. The detachment point of the relevant tranche
4. Cumulative losses

Residential Mortgage Exposures:

1. Mortgage category 1 or 2 determination
2. Loan-to-value ratio

Sovereign Entity Debt Positions:

1. Organization for Economic Co-operation and Development Country Risk Classifications (CRC) Score

Table 6 shows our estimate of the number of hours it will take small and large institutions to perform the activities necessary to meet the requirements of the proposed rule. We base these estimates on the scope of work required by the proposed rule and the extent to which these requirements extend current business practices. We have also taken into consideration observations from comment letters regarding the burden of similar measures in a proposed amendment to the market risk rule. These observations suggest that the securitization element of the proposed rule may involve some additional data gathering before an institution is able to accurately calculate risk weights using the SSFA approach.

Although the total cost of gathering the new variables will depend on the size of the institution's portfolio, we believe that the costs of establishing systems to match creditworthiness variables with exposures and calculate the appropriate risk weight will account for most of the expenses associated with the credit rating alternatives. Once a bank establishes a system, we expect the marginal cost of calculating the risk weight for each additional asset in a particular asset class will be relatively small. We also note that it is likely that a third-party will eventually emerge to provide risk weights for these assets. Our estimates do not reflect this cost-saving innovation, however, as we cannot be sure such a provider will emerge or be retained by institutions subject to the rule.

We estimate that large financial institutions, those with assets of $10 billion or more, covered by the proposed rule will spend approximately 1,300 hours during the first year the rule is in effect. In subsequent years, we estimate that all financial institutions will spend approximately 180 hours per year on activities related to determining risk weights using the alternative measures of creditworthiness. For smaller institutions, those with total assets less than $10 billion, we estimate that they will spend approximately 425 hours during the first year the rule is in effect. Most smaller institutions do not lend to foreign governments or banks in foreign countries, and they do not hold foreign debt securities. Thus, for smaller institutions, we include system and compliance costs related to sovereign debt in the system and compliance costs for other positions.

Table 7 shows our overall cost estimate related to the determination of risk weights using the measures of creditworthiness in the proposed rule. Our estimate of the compliance cost of the proposed rule is the product of our estimate of the hours required per institution, our estimate of the number of institutions affected by the rule, and an estimate of hourly wages. To estimate hours necessary per activity, we estimate the number of employees each activity is likely to need and the number of days necessary to assess, implement, and perfect the required activity. To estimate hourly wages, we reviewed data from May 2010 for wages (by industry and occupation) from the U.S. Bureau of Labor Statistics (BLS) for depository credit intermediation (NAICS 522100). To estimate compensation costs associated with the proposed rule, we use $85 per hour, which is based on the average of the 90th percentile for seven occupations (i.e., accountants and auditors, compliance officers, financial analysts, lawyers, management occupations, software developers, and statisticians) plus an additional 33 percent to cover inflation and private sector benefits.[6] As shown in table 7, we estimate that the cost of introducing alternative measures of creditworthiness is approximately $46.5 million.

2. Disclosure Requirements

The proposed rule requires institutions with total assets of $50 billion or more to disclose information on a somewhat lengthy list of structural and financial variables. We estimate that meeting the disclosure requirements will entail approximately 520 hours during the first year the proposed rule applies, and this will cost the affected institutions approximately $44,200 in the first year. We estimate that the time necessary to meet the disclosure requirements in subsequent years will diminish substantially, to roughly 25 hours per quarter or 100 hours per year. We estimate that approximately 23 OCC-regulated institutions will be subject to the disclosure requirements in the proposed rule, resulting in a cost of $1.0 million.

3. Overall Cost Estimate for Standardized Approaches for Risk-weighted Assets

Combining our estimates of capital costs ($45.7 million), the cost of applying alternative measures of creditworthiness ($46.5 million), and disclosure requirements ($1.0 million), our overall estimate of the cost of the proposed rule (NPR2) is $93.2 million.

[6] According to the BLS' employer costs of employee benefits data, thirty percent represents the average private sector costs of employee benefits.

Table 6. Estimated Annual Hours for Creditworthiness Measurement Activities

Asset	Activity	Estimated hours per institution with total assets < $10 bil.	Estimated hours per institution with total assets ≥ $10 bil.
Securitization	System development	120	480
	Data acquisition & Due Diligence	80	240
	Calculation, verification, and training	60	120
Residential Mortgages	System development	60	60
	Data acquisition	30	50
	Calculation, verification, and training	10	10
Sovereign Debt	System development		80
	Data acquisition		30
	Calculation, verification, and training		60
Other Positions Combined[7]	System development	40	80
	Data acquisition	20	30
	Calculation, verification, and training	5	60
Total Hours		425	1,300

[7] Includes sovereign debt implementation costs for institutions with less than $10 billion in assets.

Table 7.
Estimated Costs of Creditworthiness Measurement Activities, December 31, 2011

Institution	Number of institutions	Estimated hours per institution	Estimated cost per institution	Estimated cost
Small banking organizations (assets < $10 bil.)	1,177	425	$36,125	$42,519,125
Large banking organizations (assets ≥ $10 bil.)	36	1,300	$110,500	$3,978,000
Total	1,213			$46,497,125

Regulatory Flexibility Act (RFA) Analysis

As part of our analysis, we considered whether the proposed rule is likely to have a significant impact on a substantial number of small entities, pursuant to the RFA. The size threshold for small banks is $175 million. Tables 8 and 9 show our estimates of the number and capital shortfall for small institutions under the proposed rules (NPR1 and NPR2). We estimate that the cost of lost tax benefits associated with increasing total capital by $143 million as shown in table 9 will be approximately $0.8 million per year. Averaged across the 56 affected institutions, the cost is approximately $14,000 per institution per year. From table 7, we estimate that the cost of implementing the alternative measures of creditworthiness will be approximately $36,125 per institution. For the 56 institutions with a projected capital shortfall, we estimate that the cost of the standardized approaches for risk-weighted assets will be slightly more costly at approximately $50,000 per institution.

To determine if the proposed rule has a significant economic impact on small entities we compared the estimated annual cost with annual noninterest expense and annual salaries and employee benefits for each small entity. If the estimated annual cost was greater than or equal to 2.5 percent of total noninterest expense or 5 percent of annual salaries and employee benefits we classified the impact as significant. The proposed rule will have a significant economic impact on 500 small national banks and 253 small federally chartered private savings institutions. Accordingly, the proposed rule appears to have a significant economic impact on a substantial number of small entities.

Table 8. – Cumulative Number of Small OCC-Regulated Banking Organizations Short of the Transition Schedule for Minimum Capital Requirements and Estimated Risk-weighted Assets, December 31, 2011

		Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	NBOs	6	8	9	10	16			
	FCPSIs	2	3	3	3	7			
	Total	8	11	12	13	23			
Tier 1 to Risk-Weighted Assets	NBOs	7	8	11	13	22			
	FCPSIs	3	3	5	5	13			
	Total	10	11	16	18	35			
Minimum Total Capital + Conservation Buffer	NBOs	15				17	22	27	37
	FCPSIs	10				11	13	17	19
	Total	25				28	35	44	56

Table 9. – Capital Shortfall for Small OCC-Regulated Banking Organizations for Scheduled Minimum Capital Requirements and Estimated Risk-weighted Assets, ($ in millions) December 31, 2011

		Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	NBOs	$8	$21	$25	$30	$54			
	FCPSIs	$1	$2	$3	$3	$10			
	Total	$9	$23	$28	$33	$64			
Tier 1 to Risk-Weighted Assets	NBOs	$25	$29	$39	$45	$75			
	FCPSIs	$1	$2	$4	$5	$16			
	Total	$26	$31	$43	$50	$91			
Minimum Total Capital + Conservation Buffer	NBOs	$58				$67	$76	$94	$111
	FCPSIs	$9				$13	$17	$25	$32
	Total	$67				$80	$93	$119	$143

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Carl Kaminski, Legislative and Regulatory Activities

Thru: Gary Whalen, Director, Policy Analysis Division

From: Douglas Robertson, Senior Financial Economist, Policy Analysis Division

Date: May 30, 2012

Subject: Impact Assessment for the Basel III Rule: Advanced Approaches, NPR3

This memorandum provides our assessment of the economic impact of the proposed rules that would implement the Basel III framework developed by the Basel Committee on Banking Supervision. The Basel III framework would revise current general risk-based capital rules and would be applicable to all banking organizations. The federal banking agencies are implementing Basel III through three separate rules. The first rule would apply Basel III minimum capital requirements to all banking organizations (NPR1). The second rule would implement new alternative measures of creditworthiness for all banking organizations (NPR2).[1] The third rule would apply Basel III enhancements to the risk-weighted assets of institutions subject to the advanced approaches capital rules (NPR3). Advanced approaches banking organizations are those institutions with total assets of at least $250 billion or foreign exposures of at least $10 billion, or institutions that have elected to adopt the advanced approaches.

1) Basel III NPR (NPR1)
This will include the changes to the numerator of the risk-based capital ratio, the new ratio requirements (common equity Tier 1 and the higher minimums), as well as the conservation and countercyclical buffers. It also will include the changes to the treatment of mortgage servicing assets and deferred tax assets (DTAs).

2) Standardized Approach NPR (NPR2)
This will include the changes to the calculation of risk-weighted assets (the denominator of the risk-based capital ratio), except for the treatment of mortgage servicing assets and DTAs discussed in the Basel III NPR.

[1] These rules would serve as the generally applicable capital rules and therefore would be a floor for the risk-based capital requirement for advanced approaches banks under Section 171 of the Dodd Frank Act.

3) Advanced Approaches NPR (NPR3)
The advanced approaches NPR will introduce enhancements to the advanced approaches rule, and it will include a proposal to expand the scope of the market risk rule to include thrifts.

We estimate that the first-year cost associated with higher minimum capital requirements in NPR1 will be approximately $5.1 million. We estimate that the first-year cost associated with changes in risk-weighted assets and implementation of alternative measures of creditworthiness in NPR2 will be approximately $93.2 million. We estimate that the first-year cost associated with changes in risk-weighted assets and simultaneously meeting new market risk capital requirements in NPR3 will be approximately $46.8 million. Together, we estimate that the overall cost of the three Basel III rules will be approximately $145.1 million in the first year. After introducing new systems for determining risk weighted assets in the first year, we estimate that the overall cost of Basel III in subsequent years will decrease to approximately $98.6 million per year.

I. The Proposed Rule: Advanced Approaches Risk-based Capital (NPR3)

The proposed rule would incorporate Basel Committee on Bank Supervision revisions to the Basel capital framework into the banking agencies' advanced approaches capital rules and remove references to credit ratings consistent with section 939A of the Dodd-Frank Act. The proposed rule would apply the market risk capital rule to certain savings associations.

The proposed rule would modify various elements of the advanced approached risk-based capital rules regarding the determination of risk-weighted assets. These changes would (1) modify treatment of counterparty credit risk, (2) remove references to credit ratings, (3) modify the treatment of securitization exposures, and (4) modify the treatment of exposures subject to deduction from capital. The proposed rule would also enhance disclosure requirements, especially with regard to securitizations.

The proposed rule would amend the advanced approaches so that capital requirements using the internal models methodology takes into consideration stress in calibration data, stress testing, initial validation, collateral management, and annual model review. The proposed rule would also require a banking organization to identify, monitor, and control wrong-way risk, which the proposed rule defines as the risk that arises when an exposure to a particular counterparty is positively correlated with the probability of default of such counterparty itself.

The proposed rule would also remove the ratings-based approach and the internal assessment approach for securitization exposures from the advanced approaches rule and require advanced approaches banking organizations to use either the supervisory formula approach (SFA) or a simplified version of the SFA when calculating capital requirements for securitization exposures.

Advanced approaches banking organizations would be required to calculate their risk-based and leverage capital requirements under the standardized approach (using the numerator and denominator in NPR 1 and NPR 2), as well as the under the revised advanced approaches, outlined in this proposal (NPR 3). Advanced approaches banking organizations would apply the

lower risk-based capital and leverage ratios for purposes of determining compliance with the proposed minimum regulatory capital requirements.

II. Institutions Affected By the Proposed Rule

The proposed rule (NPR3) will apply to advanced approaches banking organizations, i.e., banking organizations with total assets of at least $250 billion or foreign exposures of at least $10 billion, other banking organizations that have elected to adopt the advanced approaches, and banking organizations that are subsidiaries of banking organizations that must use the advanced approaches rules. The NPR also proposes to expand the scope of the market risk rule to apply to savings associations and savings and loan holding companies that meet the relevant trading activity thresholds – $1 billion or more in trading activity or trading activity equal to 10 percent or more of the banking organization's total assets.

III. Estimated Costs and Benefits of the Proposed Rule

Benefits of the Proposed Rule

The proposed rule would produce the following benefits:

1. Increases risk sensitivity of risk-weighted assets
2. Improves transparency and market discipline through disclosure requirements.
3. Enhances counterparty credit risk capital requirements that proved inadequate during the financial crisis

Costs of the Proposed Rule

1. Impact of Risk-weighted Assets on Capital Requirements

The modifications to risk-weighted assets in the proposed rule will affect overall risk-weighted assets and hence risk-based capital ratios for advanced approaches banks. Applying new risk weights implies that capital requirements may go down for some assets and up for others. As with NPR2, securitization exposures in particular may face higher capital charges under the proposed rule.

As with NPR2, we estimate the proposed rule's impact on risk-weighted assets by applying the average change in risk-weighted assets reported by the Basel Committee on Banking Supervision quantitative impact study working group. For the analysis of NPR3, we first estimate the effect of increasing risk-weighted assets of advanced approaches banks by 20 percent. We also incorporate estimates of the effect of the market risk rule on institutions that are subject to both the advanced approaches rule and the market risk rule.

To estimate the impact of the proposed rule (NPR3) on bank capital needs, we estimate the amount of capital banks will need to gather to meet the new minimum standards described in our analyses of NPR1 and NPR2. As with those analyses, we estimate new capital ratios and

requirements by combining various Call Report items to reflect definitional changes to common equity capital, Tier 1 capital, and total capital as described in NPR1. We also increase current risk-weighted assets by 20 percent as described in NPR2.

We thus construct new capital ratios for advanced approaches banking organizations reflecting the requirements of the proposed rules (NPR1 and NPR2) and estimate capital shortfalls as the difference between current capital levels and capital levels necessary to meet the new minimum standards. We estimate the capital shortfall each institution would encounter as the new capital ratios come into effect during the transition period from 2013 through 2019. Table 1 shows our estimates of the number of advanced approaches institutions that would not meet the transition schedule for proposed minimum capital requirements using data as of December 31, 2011. Table 2 shows our estimates of the aggregate amount of capital shortfall over the transition period ending in 2019. While institutions must simultaneously meet all of the minimum capital requirements, the largest shortfall amount in any given year shows the most binding minimum capital requirement. The number of institutions and the capital shortfall amounts shown in the 2016 column reflect those institutions that show a shortfall with regard to the new PCA standards relative to current capital levels.

Table 2 shows that $22 billion of our NPR2 estimate of a $27 billion capital shortfall is attributable to 3 advanced approaches banks that would encounter a capital shortfall in 2015 when the new Tier 1 PCA standard for well-capitalized institutions takes effect.

Because many advanced approaches banks are also subject to the market risk rule, we repeat our capital shortfall estimate by adding estimated market risk assets to the capital ratios for these institutions. Table 3 shows our estimate of the number of institutions that would need to increase capital levels to meet new minimum capital requirements. Table 4 shows our estimate of the amount of capital needed to meet those capital requirements.

We assume that the aggregate cost of increasing capital will be spread out over several years. Table 2 reflects capital amounts already included in our analysis of NPR2. To estimate the amount of required capital not accounted for in NPR2, we subtract the capital amounts shown in table 2 from those shown in table 4. This comparison suggests that the earliest significant capital requirement for advanced approaches banks will be raising $24.8 billion in capital to meet the new PCA Tier 1 standard for well-capitalized institutions when it takes effect. We estimate that the largest shortfall for any given year will be approximately $8.3 billion, or one third of the amount needed to meet this new PCA Tier 1 standard.

To estimate the cost to banks of the new capital requirement, we examine the effect of this requirement on capital structure and the overall cost of capital.[2] As with our estimates in NPR1 and NPR2, we estimate that the cost of the increase in capital would be tax benefits foregone: the capital requirement ($8.3 billion), multiplied by the interest rate on the debt displaced and by the effective marginal tax rate for the banks affected by the proposed rule. Graham (2000) estimates a median marginal tax benefit of $9.40 per $100 of interest. So, using an estimated interest rate on

[2] See Merton H. Miller, (1995), "Do the M & M propositions apply to banks?" *Journal of Banking & Finance*, Vol. 19, pp. 483-489.

debt of 6 percent, we estimate that the annual tax benefits foregone on $8.3 billion of capital switching from debt to equity is approximately $8.3 billion * 0.06 (interest rate) * 0.094 (median marginal tax savings) = $46.8 million per year.[3]

Table 1. – Cumulative Number of OCC-Regulated Advanced Approaches Banking Organizations Short of the Transition Schedule for Minimum Capital Requirements and Estimated Risk-weighted Assets, December 31, 2011

	Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	0	0	0	0	0			
Tier 1 to Risk-Weighted Assets	0	0	0	0	3			
Minimum Total Capital + Conservation Buffer	0				0	0	1	3
Advanced Approaches Countercyclical Buffer								1
Advanced Approaches Leverage Ratio							0	

[3] See John R. Graham, (2000), "How Big Are the Tax Benefits of Debt?" *Journal of Finance*, Vol. 55, No. 5, pp. 1901-1941. Graham points out that ignoring the offsetting effects of personal taxes would increase the median marginal tax rate to $31.5 per $100 of interest.

Table 2. – OCC-Regulated Advanced Approaches Banking Organizations Cumulative Capital Shortfall for Scheduled Minimum Capital Requirements and Estimated Risk-weighted Assets, ($ in millions) December 31, 2011

	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	0	0	0	0			
Tier 1 to Risk-Weighted Assets	0	0	0	$22,175			
Minimum Total Capital + Conservation Buffer				0	0	$2,501	$18,586
Advanced Approaches Countercyclical Buffer							$3,918
Advanced Approaches Leverage Ratio						0	

Table 3. – Cumulative Number of OCC-Regulated Advanced Approaches Banking Organizations Short of the Transition Schedule for Minimum Capital Requirements Including Estimated Risk-weighted & Market Risk Assets, December 31, 2011

	Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	0	0	0	0	1			
Tier 1 to Risk-Weighted Assets	0	0	0	1	3			
Minimum Total Capital + Conservation Buffer	0				1	1	2	4
Advanced Approaches Countercyclical Buffer								1
Advanced Approaches Leverage Ratio							0	

Table 4. – OCC-Regulated Advanced Approaches Banking Organizations Cumulative Capital Shortfall for Scheduled Minimum Capital Requirements Including Estimated Risk-weighted & Market Risk Assets, ($ in millions) December 31, 2011

	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	0	0	0	$15,061			
Tier 1 to Risk-Weighted Assets	0	0	$6,689	$46,937			
Minimum Total Capital + Conservation Buffer				$9,101	$17,473	$31,516	$57,430
Advanced Approaches Countercyclical Buffer							$23,432
Advanced Approaches Leverage Ratio						0	

2. Cost of Disclosure Requirements

The proposed rule requires advanced approaches banking organizations to amend disclosures regarding securitizations to include the following:

- The nature of the risks inherent in a banking organization's securitized assets,
- A description of the bank's policies for monitoring changes in the credit and market risk of the organization's securitization exposures,
- A description of a banking organization's policy regarding the use of credit risk mitigation for securitization exposures,
- A list of the special purpose entities a banking organization uses to securitize exposures and the affiliated entities that a bank manages or advises and that invest in securitization exposures or the referenced SPEs, and
- A summary of the banking organization's accounting policies for securitization activities.

As described in our analysis of NPR2, we estimate that meeting all disclosure requirements will entail approximately 520 hours during the first year the proposed rule applies, and this will cost the affected institutions approximately $44,200 in the first year. We estimate that the time necessary to meet the disclosure requirements in subsequent years will diminish substantially, to roughly 25 hours per quarter or 100 hours per year.

Because we included these disclosure costs along with system implementation costs in our analysis of NPR2, we do not include these expenses in this analysis. Thus, our overall estimate of the cost of the proposed rule (NPR3) is $46.8 million per year. This cost estimate reflects the

added capital burden of institutions that will be subject to both the advanced approaches capital rules and the revised market risk rule.

Regulatory Flexibility Act (RFA) Analysis

The proposed rule (NPR3) will apply to advanced approaches banking organizations, i.e., banking organizations with total assets of at least $250 billion or foreign exposures of at least $10 billion, other banking organizations that have elected to adopt the advanced approaches, and banking organizations that are subsidiaries of banking organizations that must use the advanced approaches rules. Our size threshold for small banks for RFA purposes is $175 million in assets. The proposed rule will affect six small subsidiaries of advanced approaches organizations. We do not consider this a substantial number of small institutions, and thus we believe that the proposed rule will not have a significant effect on a substantial number of small entities.

Testimony of the
National Association of Insurance Commissioners

Before the
Subcommittees on Financial Institutions and Consumer Credit
and Insurance, Housing, and Community Opportunity
Committee on Financial Services
United States House of Representatives

Regarding:

Examining the Impact of the Proposed Rules To Implement Basel III Capital Standards

November 29, 2012

Kevin M. McCarty
Commissioner, Florida Office of Insurance Regulation
and
President of the National Association of Insurance Commissioners

Introduction

Chairman Capito, Chairman Biggert, Ranking Member Maloney, Ranking Member Gutierrez, and members of both Subcommittees, thank you for the opportunity to testify today. My name is Kevin McCarty, and I am the Commissioner of Insurance for the State of Florida. I am here as President of the National Association of Insurance Commissioners (NAIC), and I present this written testimony on behalf of that organization. The NAIC is the United States standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia, and five U.S. territories. Through the NAIC, we establish standards and best practices, conduct peer review, and coordinate our regulatory oversight. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S.

As financial institutions have evolved over time, many have become larger, more diverse, and increasingly international. More often than not, these institutions are subject to a myriad of regulatory requirements designed to protect consumers of different financial products. The challenge for policymakers and regulators alike is to ensure that these regulatory requirements, designed to address different products and the different types of institutions that offer them, provide consumers with the appropriate level of protection given the unique risks each firm faces while not conflicting or otherwise being unduly burdensome to the companies subject to them.

The NAIC recognizes that certain insurance groups have made business decisions to engage in non-insurance activities, particularly banking activities, which could subject such companies to consolidated holding company supervision by the Federal Reserve. Unfortunately, in applying such consolidated supervision, the natural tendency is to eschew nuance for a seemingly simpler "one size fits all" approach. It is our long-held belief and experience that the "one size fits all" approach to regulation does a disservice to consumers and companies alike by putting in place requirements that are not appropriately sized to the risks facing the institution and its customers. In this regard, the prospect of bank-centric regulatory rules being imposed on or impacting insurance legal entities that have very different business models is quite problematic, and it is critical that the regulatory walls around legal entity insurers that have successfully protected policyholders for decades not be displaced or disrupted.

Today, I will provide the Committee with the differences between insurance and banking products, an overview of the current financial solvency framework and risk-based capital regime for U.S. insurers, discuss the NAIC's suggestions for the proposed rules relating to Basel III Capital Standards issued by the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, and finally address the related concept of global capital standards.

Differences Between Insurance and Banking Products

Insurance products are fundamentally different from banking products. Banking products involve money deposited by customers and are subject to withdrawal on demand, which the bank is liable for at any time. Insurance policies involve up-front payment in exchange for a legal promise to pay benefits upon a specified loss-triggering event in the future. The very nature of insurance significantly reduces the potential of a run-on-the-bank scenario for property/casualty, health and most life insurance products. For those limited products sold by insurers that could be subject to some level of run risk, mitigating factors exist such as policy loan limitations, surrender/withdrawal penalties, and additional taxes. Additionally, insurers typically maintain a diverse product mix so only a portion of the company's products would be subject to the already reduced level of run risk.

Importantly, insurance products unlike other financial products, do not transform short term liabilities into longer term assets. Insurance has shorter duration liabilities in many of the property/casualty and health product lines, and the assets held are similarly short term. Insurance has longer duration liabilities in life and annuity product lines, and these liabilities are matched against similarly longer term assets. This is a critical distinction from banking and other financial products. The reason many other financial firms suffered during the financial crisis was that the duration of their assets and liabilities were not matched in a way that enabled them to fund their liabilities when they came due.

Insurance Regulation's Financial Solvency Framework

Importantly, the national state-based system of insurance regulation was specifically designed to address the unique nature of insurance products. The system's fundamental tenet is to protect policyholders by ensuring the solvency of the insurer and its ability to pay insurance claims. Strict standards and keen financial oversight are the hallmarks of our solvency framework. Such regulatory oversight begins with the premise that insurance companies are different from other financial institutions and the products they sell are different. It is for this reason that insurance regulators purposely avoid "one size fits all" approaches and, instead, opt for company and product specific analysis and examination. In this regard, while insurer capital requirements are important, such requirements are not a substitute for the other tools in the regulatory tool chest and, if imposed incorrectly, can be unnecessarily onerous to the company and ultimately harmful to the policyholder.

State laws and regulations provide the structure of the financial solvency framework, requiring insurers to be licensed before selling their products or services. All U.S. insurers are subject to regulation in their state of domicile and in all other states where they are licensed to sell insurance. Such licenses are unique to the types of products that an insurer wishes to sell. Regulators assess the license application, which includes a review of the ownership structure,

quality and history of management, internal controls, and projected financial condition. Insurers who fail to comply with regulatory requirements are subject to license suspension or revocation, and states may exact fines for regulatory violations.

Detailed and transparent insurer reporting and disclosure requirements are equally critical components of our solvency framework. Insurers are required to prepare comprehensive financial statements using the NAIC's Statutory Accounting Principles (SAP). SAP utilizes the framework established by Generally Accepted Accounting Principles (GAAP), but unlike GAAP which is primarily designed to provide key information to investors of public companies and looks at ongoing-concerns, SAP is specifically designed to assist regulators in monitoring the solvency of an insurer by using more of a winding up approach.[1] Thus, the assets, liabilities and surplus reported in statutory financial statements are typically much more conservative. The NAIC's Accounting Practices and Procedures Manual includes the entire codification of SAP and serves as the consistent baseline accounting requirement for all states. Unlike GAAP which provides for consolidated financial statements for an entire holding company, the financial statements filed with the NAIC are prepared using SAP at the legal entity insurer level.

Quarterly and annually, each insurer must file financial statements with the NAIC, including a balance sheet, an income statement, and numerous schedules and exhibits showing financial conditions. The NAIC serves as the central repository for this data, including running automated prioritization indicators and sophisticated analysis techniques enabling regulators around the country to have access to national-level data without the redundancy of reproducing this resource in every state. This centralized data and analysis capability was cited by the International Monetary Fund as "world-leading" in its most recent assessment of U.S. insurance regulation.[2]

Insurance regulators utilize the financial statements and other information as part of their continuous, intensive financial analysis to identify issues that could impact solvency. At least every quarter, regulators assess a company's reserve adequacy, leverage, liquidity, surplus, asset quality, investment concentration, or other trends reflected in the filings. Every 3-5 years, regulators engage in full scope on-site examinations. Such exams are risk-focused and are used as a means of validating that the insurer's systems are performing as claimed in their financial statements and regulatory filings. On an ongoing basis, insurance regulators assess business plans, material transactions, and any reputational or contagion risk posed by such transactions to determine whether to approve, deny, or require additional solvency protections. They analyze impacts of major economic and insurance events through the use of special data requests and stress testing.

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[1] A detailed presentation on differences between SAP and GAAP was appended to the NAIC's October 22 Comment letter on proposed Federal Regulatory Capital Standards, available at: http://www.naic.org/documents/cipr_testimonies_121022_basel3.pdf.

[2] 2010 International Monetary Fund Country report No. 10/126, "United States: Publication of Financial Sector Assessment Program Documentation – Detailed Assessment of Observance of IAIS Insurance Core Principles."

As part of our solvency system's "Windows and Walls" approach to group supervision, insurers are required to report on any reputational or other contagion risks posed by non-insurance affiliates, the "windows" into the rest of the group. In the event of the insolvency of an affiliate of an insurer, regulators have the authority to "ring-fence" the insurance company, thereby preventing the affiliate from endangering the solvency of the insurer and protecting policyholders. These are the "walls" in the "Windows and Walls" approach.

Insurers are required to have a certain amount of capital and surplus to establish and continue operations. The NAIC risk-based capital (RBC) system[3], which is embedded in statute in all 50 states, was created to provide a capital adequacy standard that is related to risk, raises a safety net for insurers, is uniform among the states, and provides regulatory authority for timely action. It requires an insurer to hold a minimum amount of capital based on analysis of risks on the insurer's balance sheet before regulatory action is triggered, but it is a regulatory tool not intended to be used as a target capital amount.

The RBC system has two main components: 1) the RBC formula, that establishes a hypothetical minimum capital level that is compared to a company's actual capital level, and 2) statutory authority granting successive levels of regulatory intervention power, based upon risks assessed in the formula compared to the insurer's capital amount. A separate RBC formula exists for each of the primary insurance types: Life, Property/Casualty, and Health. The formula focuses on the material risks that are common for the particular insurance type. For example, interest rate risk is included in the Life RBC formula because the risk of losses due to changes in interest rate levels is a material risk for many life insurance products. Investment and other asset risks, on the other hand, are experienced by all insurers and so are included in all three formulas. Investment risk includes: default of principal and/or interest for bonds and mortgage loans, default and passed dividends for preferred stock, decrease in fair value for common stock and real estate. Other asset risks included in the formulas cover credit risk and concentration risk.

There are five outcomes to the RBC calculations, which are determined by comparing a company's Total Adjusted Capital to its Authorized Control Level RBC. The level of required RBC is calculated and reported annually. Depending on the level of reported RBC, a number of remedial actions, if necessary, are available as follows: (1) No action; (2) Company action level; (3) Regulatory action level; (4) Authorized control level; (5) Mandatory control level.

The Proposed Federal Capital Rules

The NAIC provided its official comments to the rules proposed by the Federal Reserve, the OCC, and the FDIC on October 22, 2012. While our focus in the written comment was to provide technical clarifications on the specific insurance related questions set forth in the

[3] A more detailed overview of the RBC system is available at: http://www.naic.org/documents/committees_e_capad_RBCoverview.pdf.

proposed rules, we want to emphasize our interest in promoting an open dialogue that will help these agencies better understand the insurance business model and regulatory regime in order to develop an approach that best captures the risk involved in supervising the consolidated entities, while respecting the existing regulation of the insurance entity.

We believe it is imperative that in their efforts to appropriately regulate thrift and bank holding companies, Federal regulators have the information necessary to craft rules appropriate to the risk profiles of the enterprises being regulated. We remain concerned with the bank-centric approach the proposed rules appear to take, and continue to emphasize that the regulatory walls around legal entity insurers should not be displaced or disrupted.

To that end, we provided input on the proposed definitions of separate accounts and policy loans, which may be in conflict with state law and may need to be re-evaluated for risk-weighting purposes, respectively. We also discussed the use of RBC for managing underwriting risk, the requirements for surplus note reporting, and laid out the differences between SAP and GAAP accounting, all of which I described to you earlier. Of particular concern is the proposal's treatment of RBC as a minimum capital requirement for insurers, rather than as a regulatory trigger for intervention. Given that insurers typically hold significantly more capital than the RBC trigger levels, the proposed rule suggests either a misunderstanding of insurer capital or an implication that capital above the minimum RBC levels is "excess" and therefore available to support capital deficiencies created by actions of the holding company or other affiliates. We would strongly object to policyholder dollars being used without insurance regulator approval to subsidize losses of the holding company.

We fully recognize the need for capital transfers within groups. However, state insurance regulators have statutory authority, laid out above, to restrict extraordinary dividend amounts used to accomplish such transfers to other group entities to maintain an adequate level of capital and surplus in the legal entity insurer to protect policyholders – considering current and prospective risks. This adequate level of capital is an amount much higher than the minimum RBC amount.

We further indicated to the Board that insurers typically have different liquidity needs and rely more on unassigned funds than other financial institutions and, therefore, have less of a need to issue various types of capital instruments. Finally, we provided the agencies with data regarding the total amount of outstanding surplus notes and the significance of that amount relative to industry capital and surplus.

While the focus of the proposed rules and this hearing is the implementation of the Basel III capital requirements, even more important than a capital requirement, minimum or otherwise, is ensuring appropriate regulatory requirements for risky activities and active solvency oversight. Capital requirements alone cannot enhance the safety and soundness of complex financial institutions – they are just one tool in a bigger toolbox. For instance, the Basel III capital

requirement would not have prevented the AIG meltdown. Regulatory requirements need to be applied to unregulated financial risks, e.g., requiring reserves for risks written or limiting the ability to write derivatives for a certain threshold of covered positions. Frequent solvency monitoring, off-site and on, must be performed; and risks of unregulated entities within the group must be a part of this monitoring. As the Federal Reserve develops its consolidated supervision regime for bank and thrift holding companies that are engaged in insurance activities, we welcome the opportunity to discuss our regulation of insurance entities as well as approaches to supervision that takes into account the unique nature of insurance companies and products.

Global Capital Standard

In addition to the regulatory changes occurring domestically, it is important to recognize that changes are, at the same time, occurring internationally as well. Insurance markets have evolved over the years to become increasingly global, interconnected, and convergent – a trend that will undoubtedly continue in years to come. Indeed, we recently welcomed nearly 600 of our regulator colleagues from across the globe to Washington, DC for the IAIS annual conference. At that forum and others, state regulators continue to show that we are heavily invested in the future of insurance globally, and the NAIC is committed to coordinating with our international regulator colleagues to ensure open, competitive, stable markets around the world. In this regard, the most important thing we can do is to promote a level playing field across the globe through strong regulatory systems while recognizing that there will continue to be cultural, legal, and operational differences in regulatory regimes around the world. Our national state-based system in the U.S. has a strong track record of evolving to meet the challenges posed by dynamic markets, and we continue to believe that well-regulated markets both here and abroad make for well-protected policyholders.

With that said, I want to address the concept of a global capital standard for insurance, which has previously been raised at the IAIS and in the context of the Common Framework project, or "ComFrame." Much in the same way a bank-centric, one-size fits all approach to capital standards is not appropriate domestically, it is also not appropriate at the global level for numerous reasons.

Firstly, state regulators are concerned that an overconcentration on capital calculations can breed a dangerous overconfidence in the ability to measure requirements perfectly. Capital requirements are but one of many tools in the U.S. system, and go hand in hand with solvency, monitoring, enforcement, and the world-leading data collection described earlier.

Furthermore, a single global group capital standard also runs the risk of itself creating systemic risk: if it is wrong or creates the wrong incentives, there is no fallback, whereas diversity of regulation and requirements minimize the scope of such an eventuality. Total uniformity is neither necessary nor prudent, especially given that most insurance products are still local, and

that there is far less ability on the part of international insurers to participate in local markets without meeting local regulatory requirements.

Thirdly, the entire point of solvency capital is the protection of policyholders when things go wrong and local capital requirements at the insurer level are needed – it is for this reason that the NAIC believes arguments about regulatory arbitrage or a level playing field miss the point. A capital standard is not for when things are going well – it's a backstop for when everything goes wrong. Unless the so called global capital standard for insurers is to be looked at on a legal entity basis, fungibility of capital in a crisis is likely to be a serious impediment to achieving any sensible global capital standard requirements. Any assessment of group capital cannot be a unilateral exercise; it requires the understanding of local jurisdictional capital requirements, the assessment of intra-group transactions, the accounting framework, the nature and fungibility of capital, and the use of stress testing. Indeed, the existence of global capital standards in the banking sector did not prevent the last crisis, and overlaying such an approach on the insurance sector could exacerbate the next crisis.

Conclusion

In light of the 2008 financial crisis and subsequent developments, the insurer business model continues to evolve. We at the NAIC, along with our fellow financial regulators at the federal and global levels, must also evolve and improve the way we supervise our markets. We must continue our ongoing efforts to develop better structures and tools to help us anticipate risk.

We will continue to work with and advise our federal and international colleagues as they gain a better understanding of existing financial standards required of insurers here in the United States and seek to assist them in developing a regulatory approach that appropriately captures the complete risk profile of an insurance enterprise, while keeping in place the walls of legal entity insurance regulation that protect policyholders. We look forward to sharing our expertise and experiences regulating insurers here in the United States, which we hope will assist our colleagues as they continue to implement capital and other regulatory changes here at home and abroad.

Thank you again for the opportunity to be here on behalf of the NAIC, and I look forward to your questions today.

November 29, 2012

Testimony of

Daniel T. Poston

On behalf of the

American Bankers Association

before the

Subcommittee on Financial Institutions & Consumer Credit
and
Subcommittee on Insurance, Housing and Community Opportunity

of the

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Chairman Capito, Ranking Member Maloney, Chairman Biggert, Ranking Member Gutierrez, and members of the subcommittees, my name is Daniel T. Poston and I am the Chief Financial Officer of Fifth Third Bancorp, a regional bank based in Cincinnati, Ohio with retail branches in 12 states including West Virginia and Illinois. I appreciate the opportunity to be here to represent the American Bankers Association (ABA) and will testify on the impact that the proposed Basel III rules would have on the entire banking industry and on regional banks like Fifth Third.

ABA represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its two million employees. Fifth Third is a typical regional bank: we are a traditional banking organization that is domestically focused, serving our local communities by providing traditional banking services—primarily deposits, loans, and trust and asset management services. We do not have large trading or capital markets businesses. Most regional banks like ours are banks between $50 billion and $250 billion in assets, that are not subject to the Advanced Approaches framework that applies to internationally active banks or "core" banks above $250 billion.[1]

As an industry, we strongly support standards for appropriate levels of high quality bank capital. We also support a more risk-sensitive system of generally applicable rules, one that works well and applies broadly, that identifies risks where and as they are, and that treats similar risks with

[1] I would note that there are three institutions that are traditional regional banks of similar characterisics to our bank and other regional banks but have approximately $300 billion of assets, making them subject to the Advanced Approaches.

similar capital treatment. A strong capital position enhances the ability of the banking sector to serve customers and promote economic growth.

Banks have shown our commitment to increasing and strengthening the capital base in recent years. Even under ***current*** capital standards, capital levels are at historically high levels. In fact, the industry's ratio of tangible common equity to tangible assets (the TCE ratio) ended the quarter at 9 percent, which is the strongest capital level since the Great Depression.

Thus, the issue here is not about higher levels of capital, as it is widely recognized that more capital would have made the financial problems for banks less severe in the last crisis. Rather, it is the complex operation of the Basel III proposals, the volatility of capital measures, and the arbitrary – and excessive – risk weights that will hurt banks, our customers, and the U.S. economy overall.

The proposals related to mortgages, for example, would lead to a significant contraction in the mortgage market, completely upset home equity lending, and further tighten and raise the cost of mortgage and home equity credit for borrowers. Some proposals specifically target many safe and sound mortgage products and services for harsh capital treatment, driving up costs and compelling banks to reduce – or even stop – their involvement in mortgage lending. In addition, the proposals require a significant amount of very granular data on a mortgage-by-mortgage basis. Most banks do not have the required data in their systems to apply this complex mortgage treatment as the proposed risk attribution framework is novel. Small businesses would also suffer, as the proposed rules penalize second mortgages, including home equity loans and lines, which are often used to start-up and support credit needs of these companies.

Changes in the treatment of capital would also have severe consequences. For example, new requirements for regulatory capital will lead to significant unnecessary capital volatility, which banks will have extreme difficulty managing. And the proposal to phase out trust preferred securities is not consistent with current law and would burden community banks that would not easily find ways to replace this capital.

A transition period for implementation—which regulators have proposed—is not the answer to this problem. Implementing fundamentally flawed rules would be a mistake. Moreover, the impact of finalized rules would take effect almost immediately. Investors expect that banks need to meet phased-in capital standards early to eliminate or reduce uncertainty regarding potential future capital issuance. And because mortgages and home equities are typically 15-30 year assets and

contracts, banks cannot allow themselves to put on assets that would only escape punitive treatment for the first couple of years of their duration.

There is a very real cost in holding higher and higher levels of capital. Most disruptive would be higher capital driven by onerous and complex risk-weighting rules that have not been demonstrated to be appropriate or accurate. Many banks will find that the only feasible alternatives are to shrink operations and reduce our service to our existing and potential customers. The result would be fewer mortgages, fewer commercial loans and less flexibility in reasonably pricing our deposit and loan products to our customers.

Rules with the power to create significant economic dislocations must be carefully considered and based on strong analytical research. This was not the case in this rulemaking. ***Therefore, we believe the proposed Standardized Approach should be withdrawn and an empirical study undertaken.*** This will better inform the development of an appropriate set of rules. All banks, large and small, would benefit from an effective but less complex replacement for Basel I. In the desire to make changes, it should not be forgotten that the more complex the rules and the larger the change, the more likely they are to create unforeseen and detrimental consequences to our economy.

We recognize and appreciate that banking regulators have indicated that they will carefully consider the many observations and comments made by the industry. It is our hope that as the banking agencies move forward, they will engage in close consultation with Congress and our industry. We look forward to working with Congress, regulators and others to address these issues, for the good of all.

In the remainder of my testimony, I will concentrate on the following four key points:

- The proposed capital requirements would unnecessarily burden economic activity;
- The proposed risk weights would redirect credit in an abrupt and harmful manner;
- Empirical study is needed to develop capital rules that work for the U.S. banks, large and small; and
- Capital rules for all banks should be simpler and more directionally and proportionally aligned with risks.

I. The Proposed Capital Rules Would Unnecessarily Burden Economic Activity

The industry generally supports the proposed increase in required minimum capital, although we have significant concerns with certain aspects of the definition of capital and the operational aspects of the proposed Basel III capital rule. These proposed requirements would replace the generally applicable capital minimum requirements for all U.S. banks, based on Basel I, which have been in place for several decades.

Increased capital levels are a prudent response to our experience of the past several years, and banking regulators, political leaders, and the public support such increases in generally applicable capital requirements. Increased capital requirements are not free–capital is expensive and that added cost means higher cost of credit for customers. Nevertheless, we generally believe that the proposed minimum levels, if appropriately tailored to risk, represent a prudent balance between safety and soundness and impact to the economy through higher costs and pricing.

Proposed Treatment of Unrealized Gains Would Constrain Banks' Ability to Manage Interest Rate Risk and Liquidity

While the Basel III Capital proposal is generally consistent with the international Basel III framework, we believe U.S. regulators should modify selected aspects of Basel accords for U.S. banks, where appropriate, as they have done with previous Basel frameworks. One of those areas is that unrealized gains and losses on available-for-sale securities have not been included in the U.S. generally applicable capital measurements. We believe—and virtually all U.S. banks large and small agree—that ***excluding unrealized gains and losses is critical to enabling banks to appropriately manage their overall interest rate and liquidity risk***.

Many banks, including Fifth Third, currently have significant net unrealized gains which would actually increase their capital levels under the proposed rules. We believe that in a typical stressed environment such as that experienced recently, the inclusion of unrealized gains or losses in capital calculations would be more likely to increase capital than decrease it. However, we expect that interest rates are likely to increase in the future. When that happens, unrealized gains would likely become unrealized losses and, under the proposal, would decrease capital levels solely due to the impact of the increase in interest rates on securities portfolios. Our recommendation on this matter

is not so much about reductions in capital but instead about banks being able to appropriately manage the overall risk of our portfolios, which include many assets other than investment securities as well as all of our liabilities.

The industry believes that the current exclusion of such gains and losses, which was prudently put in place for these very reasons, should remain in place. Further, banks use these investment security portfolios to prudently manage both interest rate and liquidity risk, and removal of the filter could seriously impact the ability of banks to prudently manage such risks. We also do not believe it would be sensible to institute this change in U.S. rules in advance of new liquidity rules being considered by regulators, which would compound the challenge of managing those rules, and we would ask that it be left out, at least for the time being.

The proposed phase out of Trust Preferred Securities (TruPS) as Tier 1 capital instruments is inconsistent with the grandfathering Congress provided for these instruments (for institutions between $500 million and $15 billion in consolidated assets). These instruments were eliminated as Tier 1 capital for banks larger than $15 billion. The ABA supports maintaining the grandfathered treatment under current law. To invalidate usage now would be a very significant burden to the capital plans of many community banks and would force them into very expensive alternatives to replace what is now working quite well. Community banks face greatly reduced alternatives in raising capital. Many smaller banks have fewer alternatives to raise capital. With limited liquidity for shares and with limited options for obtaining replacement capital, smaller banks would be especially hard pressed to come up with suitable alternatives at a reasonable cost. These banks would potentially find it necessary to shrink to meet the capital requirements, thus reducing lending to businesses and consumers, including residential mortgages and small business loans.

There are other aspects of the Basel III Capital proposal which merit careful consideration and are included in the more than 2,000 comment letters that have been sent to the regulators. We believe these issues have solutions that could be resolved in relatively short order and would be appropriate for all banks, large and small, as is the case under current rules.

Most banks have strong capital positions, well above minimum requirements, for a variety of reasons. However, smaller banks, including especially banks organized in mutual form, have less immediate market access to capital and generally rely on retained earnings to add to their capital. Therefore, the ABA has supported a delay in the application of any Basel III Capital proposal for smaller banks until July 2015, approximately two years after its general application. It is in the

public interest for community banks to be successful, just as it is in the public interest for all banks to have strong capital appropriate to their risks.

II. The Standardize Approach Would Redirect Credit in an Abrupt and Harmful Manner

The higher capital requirements in the Basel III Capital proposal would be expected to raise the price of credit but should not cause a significant redirection of credit flows in the broader economy. ***The Standardized Approach NPR, in contrast, would redirect credit in what we believe would be fairly abrupt and yet un-quantified ways***. We believe it would have a far reaching impact on all banks, small and large, and on their customers.

The ABA strongly recommends that the Standardized Approach be withdrawn and that careful empirical studies be conducted to evaluate its attribution of risk and its impact to banks, borrowers, and the economy. At Fifth Third, we support this approach, as do other regional banks like ours. This standardized risk weight framework of capital attribution was never considered or proposed in previous forms of standardized approaches. Banks were informed of these proposed risk attributions in June, and it has proven extremely difficult for them to even estimate the complex interactions the proposed rules would have on their risk weighted assets. Some have provided these estimates to the market, though without much detail, and as a result there is still no basis to actually estimate the impact of the Standardized Approach to the industry overall or to most of its participants.

The industry provided thousands of comments to the agencies regarding this proposal. While all the issues of importance are too numerous to discuss, it is worth noting that, in addition to the problems detailed throughout this statement, ABA and its member banks are particularly concerned that the proposed Standardized Approach:

- Mismatches risk among asset classes;
- Risk weighs non-performing loans lower than some performing loans, including certain home equity loans and lines;
- Causes risk weights under the rule to exceed the value of the asset.

The Proposed Framework Will Have Significant Negative Impacts on Mortgage Availability

The proposed framework for risk-weighting mortgages is based upon ***qualitative*** attributes of loan products that create the potential for risk, without considering other key underwriting factors, the appropriateness of the loan for that borrower, or the credit-worthiness of the borrower. These factors, along with loan-to-value ratios (LTVs), were the actual dominant causes of differential loss experience during the crisis, as they have always been. As such, banks' management of risk is oriented toward those very factors. They manage risk and pricing, using LTVs, debt-to-income ratios, credit scores, and other measures known to provide strong prediction of credit risk. The product types that are appropriate for borrowers differ, based on borrower preferences and these attributes. Assigning risk to product type before considering underwriting ignores the key role of underwriting in determining risk and product appropriateness. Previous standardized risk-weight proposals were much less complex and much more aligned with identified sources of risk, and we encourage the revisiting of those proposals.

Key concerns outlined in industry and individual bank comment letters include the assumption that many traditional hybrid ARM mortgages and many mortgages with balloons or interest deferral periods have double the risk of other loans.[2] We fully agree that some mortgages are riskier than others—for example, mortgages with higher LTVs, higher debt-to-income, and lower FICO scores are generally riskier than the reverse—but we do not believe that loans with the above attributes are automatically risky and all of them are certainly not twice as risky as other mortgages.

While we believe the proposed framework for categorizing mortgages is problematic, ***the effect of the proposal on home equity loans would be profound.*** This is because of the impact of home equities on the risk weightings for first mortgages, held by a lender that also made or makes a home equity loan to the same borrower. Home equity lines of credit have been found to have performed relatively well during the crisis, likely because they tended to be provided to relatively higher

[2] Banks are very concerned about the treatment of balloon mortgages, particularly given their importance as an effective interest rate risk management tool. These loans also provide a means to balance property prices and affordability, which is especially difficult in higher cost states like New York and California. In fact, in some areas, such as rural communities, balloon loans are the only product that may be offered. Importantly, many banks can demonstrate that, when properly underwritten, balloon (and interest-only) loans have a strong historical performance. The evidence that balloons can be made safely makes for a very strong example against an assumed automatic high risk weighting for them. We do not believe that treating these loans punitively is justified unless the banking agencies are able to prove that such mortgages are risky despite proper underwriting. Adjustable rate mortgages, likewise, enable banks to hold them while protecting against interest rate risk, while also being a product that is appropriate for and desired by certain consumers.

quality borrowers.[3] However, they often have one or more features that would cause them to be assigned to "Category 2" attracting double risk-weightings. (These common characteristics for home equity lines include floating indexed rates, interest-only periods, and / or balloon maturities.) The proposal requires home equity loans and first mortgages made by the same lender to be combined for purposes of evaluating the loan-to-value of both the first and second lien (despite the first lien having a lower LTV and having priority right to the collateral), and using the category of the second lien to determine that of the first (despite the senior lien not having any such characteristics and being fully senior to the junior lien).

First lien mortgage loans are usually much larger than second lien loans and, therefore, this methodology can and will cause small home equity loans to double (or more) the risk weighting of a first mortgage on the same property (because of the risk-weighted asset inflation it causes to the first mortgage). The effective risk weighting for such a home equity loan could easily be in the many hundreds of percent.[4] In contrast, a junior lien provided by another lender would be risk weighted at its direct risk weight of 100-200 percent. We believe this disparity may make it impossible for banks to provide competitive home equity products at a reasonable price to their own customers, despite there being no difference in risk for the home equity loan based upon who provides it.[5] Home equity loans and lines of credit are commonly provided to borrowers for many purposes, including small business investment. These purposes are important to the economy, and utilize part of the borrower's net worth in the form of equity they have built in their homes to conduct these activities. In short, we believe this combining of first and second liens should be eliminated from a re-proposal, except in the cases of piggybacks, and first and second mortgages risk-weighted independently.[6]

There are other aspects of the Standardized Approach for which we believe the industry has made constructive comments, including aspects of the treatment of early default guarantees for sold mortgages, "high volatility commercial real estate" (HVCRE) and securitization treatment. These

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[3] Donghoon Lee et. al., Federal Reserve Bank of New York, August 2012.

[4] Because this is so counter to economic reality and experience, it is also a prime example of how the Standardized Approach would produce very different results than under the Advanced Approaches, which is based upon economic reality and experience.

[5] A lender subject to the Standardized Approach in competition with a lender not subject to it would have difficulty competing for certain mortgages or home equities at all.

[6] We suspect that a concern about piggyback lending – issuing and funding a first and second lien simultaneously to a customer to reduce down-payment requirements – is the source of this aspect of the proposal. We and the American Bankers Association (and its joint comment letter partners) have proposed instead that simultaneously funded first and second liens be the only loans that are combined for determining the applicable LTV for the first mortgage. These borrowers should not be penalized to address a form of risk that can instead be addressed directly.

have been detailed in comment letters by the ABA, a regional bank working group that includes Fifth Third, as well as other letters including those from individual banks. We would be happy to provide the subcommittees with these documents and details on these other important issues.

III. Empirical Study is Needed to Develop Capital Rules That Work for All U.S. Banks

The ABA strongly recommends that the Standardized Approach be withdrawn, and that studies be conducted to evaluate its attribution of risk and its potential impact on the mortgage market, the economy, banks and their customers. We believe an empirical study of the Standardized Approach would inform the better development of an appropriate set of new rules.

We believe it is critical that any proposed changes to how banks calculate their risk weighted assets be directly aligned with actual risk and risk experience. ***A capital proposal that does not build on risk experience will redirect credit away from loans and borrowers even where the risk is appropriate for them and the lender.*** We believe it is not possible to create a set of rigid rules that fully capture the key elements of underwriting. The more complex the rules, the more likely they are to create unforeseen issues.[7] As a result, we believe an appropriate standard set of risk weights must necessarily be simpler than what has been proposed.

As of yet, it is not possible to evaluate the competitive or customer impact of the risk-weighting approaches on groups of banks or on their businesses like mortgages. Banks have only recently estimated (or are estimating) the impact, but that data has not been collected, aggregated, and then its results applied for consideration of how the "Collins Amendment" floor[8] would work or how capital buffers would and should be calculated. These issues should be evaluated through study. Just as the largest banks are concerned about competitive balance internationally, domestically focused U.S. banks are concerned about domestic competitive balance. The mortgage business is so vitally important to all banks, large and small, that if the mortgage activities of any of them are constrained through prescriptive risk-weights for certain types of risk, those constraints

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[7] For example, we understand there are non-U.S. banks (not subject to the Standardized Approach) who are investigating opportunities to acquire (at significant discounts) from U.S. banks mortgage or home equity loans which would receive punitive treatment under the rules. They would risk weight these mortgages at, say, 35 percent, or perhaps even re-securitize them to be carried at an even lower risk weight. ***Such a development would represent the transfer of value, and capital, from U.S. banks to non-U.S. banks, without a commensurate reduction in risk that would justify it.***

[8] Dodd Frank Act, Section 171 (b)(2).

should be common. A balloon mortgage or traditional ARM loan should not be more costly to make for a smaller bank than a larger bank. This is not only important for competitive reasons, but because the customers of any bank with different restrictions would also be affected differentially through no fault of their own.

We believe it would be useful for banking regulators to also evaluate the work and findings related to the FDIC's rulemaking on high risk consumer loans, which capture important elements of underwriting that are not incorporated in the approach taken with this proposal.[9]

IV. Capital Rules for All Banks Should Be Simpler, and Directionally and Proportionally Aligned with Risks

The Basel III Capital NPR and Standardized Approach NPR are proposed to apply to all U.S. banks whether or not they are internationally active. This approach – that there should be a set of common capital rules that apply to all U.S. banks operating domestically – is consistent with the current approach which has applied to such banks for decades. All banks use the same definitions for each type of capital, are generally governed by the same U.S. capital requirements, and, for a given type of risk, each bank is required to hold the same amount of capital for that risk. These factors make it critical that such a system be appropriately designed and one that all banks can implement.

Any change should represent an improvement on Basel I. ***A more risk-sensitive risk-weighting framework would be valuable in the U.S., but if mis-calibrated it could be very damaging.*** Such a proposal should be consistent with risk, be exceptionally careful not to over-ascribe risk, and not be overly complex or difficult to implement. If risk-weightings are not truly correlated with actual risks, risks would shift inappropriately among banks or to and from the banking industry to nonbanks that may be less regulated and more difficult to regulate.

Banks of all sizes, from the largest banks to community banks, have expressed remarkably consistent concerns with the substance of the proposals. The proposal for new risk weightings is overly complex and does not build on an analytical foundation from demonstrated experience, and we believe it would lead to market distortions that are neither necessary nor desirable. The added complexity of the proposed Standardized Approach has the ***appearance*** of accuracy and

[9] This was a point made by a group of regional banks in commenting on the proposals. Assessments, Large Bank Pricing, 77 FR 18109 (March 27, 2012).

sophistication, but we believe the reality is far different. It would be more appropriate to emphasize the role of appropriate supervisory oversight and judgment, rather than creating highly complex risk-weighting frameworks that are untested and unlikely to be correct either at the beginning or over time as markets change.

The implementation of a proposal of such complexity would affect all banks, and the customers of all banks, significantly. The administrative and logistical burden of data collection, management, reporting, and compliance alone would be very high for any bank. This burden is primarily related to the sheer complexity of the operations of the proposal, rather than its inclusion of greater risk sensitivity. However, as burdensome as the rules would be to implement, that burden would pale in comparison to the impact on business activities and customer disruption for any bank to which they applied, as they tried to manage conflicts where there was high attributed risk and much lower actual risk.

As proposed, the rules are overly complex and need to be simplified and aligned with risk so that they can work for all banks. As written, the proposed rules are not appropriate for banks of any size. In fact, application of any new rules based solely on the size of the bank inevitably would lead to distortions that cannot be justified by the risks taken by the institution. For example, some observers have suggested that the proposals only apply to banks greater than $50 billion, which would include banks like Fifth Third. We believe there is absolutely no reason that the proposed rules would be appropriate only for banks of our size (or larger), in the absence of any special propensity shown for taking risks or holding risk concentrations.[10] Again, banks should be required to hold similar capital for similar risks, whether they are large or small institutions. We believe a replacement for Basel I that works for smaller banks would work just as well for larger banks, including regional banks.

The appropriate way to address this is for the rules to be withdrawn, studied and, if necessary, re-proposed, in a simpler form more directionally and proportionally aligned with risk. We believe until such rules are identified and applied that would work for all banks, small and large, the current Basel I rules should remain in place for all banks.

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[10] Banks of our size, as well as the largest banks, already are subject to extensive and detailed scrutiny of our risk, at granular detail, through stress-testing and other processes. In our bank's opinion, by rule, these data reporting, capital planning and stress testing processes are far more strenuous than will ever be required for smaller institutions. Furthermore, institutions that have $50 billion in assets are already subject to very significant "cliff effects" despite the small size of our institutions relative to the banking sector or economy.

Summary

In conclusion, the ABA believes the proposed Standardized Approach should be withdrawn until further study. The issue is not whether U.S. banks have the capital for these rules—the vast majority of banks already do. It is the complex way the rules would work that would be so damaging to all banks, the mortgage market, and most importantly our customers. Therefore, careful study to ensure consistent and workable rules for all is absolutely critical given that this proposal is not required under any Basel agreement or any federal legislation.

The industry supports a more risk-sensitive system of generally applicable rules, one that works well and applies broadly, that identifies risks where and as they are, and that treats similar risks with similar capital treatment. There are nearly 7,000 banks in the United States, the vast majority of which are community banks; therefore any general risk-weights must work for these banks, or else they don't work. We believe that such an approach would be entirely appropriate for regional banks, like Fifth Third, and the risks they take as well.

Banks large and small have voiced very strong and remarkably consistent concerns about its operation of the Standardized Approach, its complexity and burdens. We urge that these concerns be carefully considered and we very much appreciate that the banking agencies have indicated they will do so.

Lawmakers, banking regulators, and bank employees are all under incredible pressure to implement many changes in the way banks are regulated in the U.S. Replacing the generally applicable rules for risk-weights is a complex process, and requires that regulators and the industry communicate and work together to calibrate risk-sensitive rules appropriately, and have the time to study and align them. This approach would better to ensure that resulting impacts to credit flows and economic activities are desirable and appropriate in both direction and scope.

The ABA appreciates the opportunity to present these views to the Subcommittees for your consideration. We look forward to working with you, regulators and others to address these issues, for the good of all.

Testimony of Paul Smith, CPCU, CLU
Senior Vice President and Chief Financial Officer
State Farm Mutual Automobile Insurance Company

before the

Subcommittee on Insurance, Housing and Community Opportunity
Subcommittee on Financial Institutions and Consumer Credit

of the

Financial Services Committee
United States House of Representatives

Joint hearing on

Examining the Impact of the Proposed Rules to Implement Basel III Capital Standards

Thursday, November 29, 2012

Introduction/Summary

Chairwomen Biggert and Capito, Ranking members Gutierrez and Maloney, and members of the subcommittees, thank you for providing State Farm Mutual Automobile Insurance Company ("State Farm Mutual") the opportunity to testify this morning on the Federal Reserve Board's (the "Board") proposals (the "Proposals") to regulate savings and loan holding companies (SLHCs) engaged in the business of insurance in the same manner as bank holding companies (BHCs) under the Basel Framework.

At the outset, I would like to emphasize that State Farm fully supports the fundamental goals of capital adequacy that underlie the proposals. However, utilizing the Basel banking–oriented framework for SLHCs engaged predominantly in the business of insurance (bereinafter, "insurance-based SLHCs"), does not satisfy these goals.

In approaching this issue, we recognize the extraordinary responsibilities, complex issues, and unprecedented number of rulemakings the Board is responsible for addressing under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). We also understand that, within the universe of entities the Board supervises, SLHCs such as State Farm Mutual comprise just a small part. Nonetheless, it does not appear that the Board gave any meaningful consideration to insurance-based SLHCs or to the most appropriate and effective alternatives to implement congressional directives. To the extent the unique needs of insurance companies were addressed, it was in the context of how the Board should treat an insurance subsidiary within a much larger banking organization.

By failing to adequately consider issues unique to insurance-based SLHCs, the proposed bank-oriented Basel framework would impose an ill-fitting and structurally flawed regulatory structure upon insurers, which have starkly different business models, risk exposures, and capital needs than banks and traditional BHCs. In addition, the regulatory mismatch creates tremendous and costly difficulties in the recordkeeping, accounting and reporting requirements for a number of insurance-based SLHCs, while offering little, if any, commensurate benefit to regulators in understanding the capital needs and financial state of the companies impacted.

Indeed, far from promoting safety and soundness for insurance-based SLHCs, these bank-oriented rules and requirements are counterproductive and may promote capital structures and practices that undermine prudential management of an insurance company.

We submit that this is not what Congress intended or mandated in the Dodd-Frank Act. Instead Congress preserved state-based functional regulation of insurance and clearly indicated that nothing in the Act was intended to replace existing and well-functioning capital and accounting regimes for insurers. Unfortunately, this reality is not reflected in the proposed rules. Consequently, unless the Board is willing to modify the Proposals to accept existing state-based capital requirements for insurers in the current rule, we believe the only responsible recourse is for the Board to issue a new proposal for insurance-based SLHCs so these issues can be addressed. We further believe that if the Board ignores existing state regulation and pushes ahead with entirely new standards for insurers, a strong case can be made that the Proposals run afoul of the McCarran-Ferguson Act, which places authority on insurance matters with the states.

Background on State Farm and its Thrift

State Farm Mutual is a state-regulated mutual insurance company established in 1922 and is the parent of the State Farm group of companies. Headquartered in Bloomington, Illinois, State Farm Mutual and its subsidiaries provide personal lines of insurance. We are the largest insurer of automobiles and homes in the United States, and although we have a substantial life insurance business, more than 85% of our revenues are provided through property and casualty insurance activities.

Our thrift was established in 1999 to meet our customers' needs for an efficient and convenient "one-stop shopping" source of products and services for the broad range of their financial services needs. Through ownership of the thrift, State Farm Mutual is a "grandfathered" unitary SLHC, as defined in Section 10(c)(9)(C) of the Home Owners' Loan Act ("HOLA").

Notwithstanding the benefits we and our customers derive from the thrift, it remains a small part of our business. More than 91% of the consolidated assets of the State Farm group are related to our insurance operations, which also generate 98% of the group's total revenues. There should be no confusion that State Farm Mutual is predominantly engaged in the business of insurance.

State Farm Mutual, is both an SLHC and an Operating Insurance Company that is Functionally Regulated on a Consolidated Basis

In addition to being overwhelmingly engaged in the business of insurance, it must be emphasized that State Farm Mutual, the holding company for the State Farm group of companies and the regulated SLHC, is also a regulated insurance company in its own right. It is not a shell holding company. It is directly regulated by the Illinois Department of Insurance (the "Illinois Department"). As such, all parts of the State Farm group are comprehensively regulated. For example, all of State Farm Mutual's subsidiaries, as assets of State Farm Mutual, are subject to holding company system examination by the Illinois Department. There is simply no material aspect of our business that is not currently subject to comprehensive prudential regulation.

Insurance regulation entails strong rules and regulations governing solvency, operations, and investments. Solvency regulations are designed to ensure that all insurance companies, including State Farm Mutual, have the financial ability and liquidity to pay claims. Regulation and laws include strict risk-based capital (RBC) requirements and statutory investment limitations and solvency requirements. Insurers also prepare financial statements on the basis of Statutory Accounting Principles (SAP) that are generally more conservative than Generally Accepted Accounting Principles (GAAP) in the valuation of assets and liabilities. Further, while State Farm Mutual has little in the way of off-balance sheet exposures, statutory accounting rules require insurers like State Farm Mutual to disclose any off-balance sheet exposures that represent a material contingency. Again, these rules are specifically designed to address the particular risks facing insurers, which are starkly different from those facing banking institutions.

This comprehensive supervisory framework for insurers is similar in approach to the supervisory system developed by bank regulators for BHCs and SLHCs that are not insurance companies; however, the insurance system has been designed to specifically address the business of insurance and the risks insurance companies face and has been highly successful.

Insurance Risk-Based Capital Requirements are Superior to the Basel Framework for Insurance-Based SLHCs

A critical component of solvency regulation is the maintenance of adequate capital and reserves. The insurance RBC calculation is intended to assess the capital adequacy of insurers and to identify and assess various risks, including asset, business, and insurance risks. As with bank capital and leverage ratios, breaches of prescribed RBC levels trigger regulatory intervention. Separate RBC formulae exist for each type of insurer (i.e., life, property and casualty, and health). Unlike some other areas of insurance law, RBC standards exhibit a high degree of uniformity across state insurance regulatory systems. RBC model laws have been adopted in their standard form in virtually every state.

Insurance RBC captures the risks associated with insurance operations, assets, and investments in a manner that is tailored to the business models and asset utilization strategies of insurers. For example, the RBC system recognizes that high-quality, long-term, investment-grade corporate bonds are a necessary component of an insurer's investment portfolio because the insurer must match longer-term, relatively stable insurance policy liabilities with long-term assets. Consequently, although the value of long-term bonds fluctuates as interest rates rise and fall, such volatility has limited impact on the financial condition of an insurer that holds the bonds to maturity because redemption of the bonds at par and other cash flows are timed to coincide with the insurer's payment obligations under the insurance policies. Importantly, the Proposals' bank-oriented focus on asset risk and inadequate recognition of insurance and other non-asset risk is troubling. The Proposals do not appropriately recognize that insurance risk is necessarily different than banking risk and that these differences impact the capital required to prudently manage each type of business.

In fact, because the calculation of capital needs for insurers and banks is so different, there are scenarios where an insurance-based SLHC could be subject to potential seizure levels under RBC guidelines, but would look well-capitalized under the Basel "consolidated" framework. Thus, if the goal of the Proposals is to ensure the capital adequacy and financial safety of regulated holding companies, the Basel framework contains gaping holes that fail the test for insurance-based SLHCs.

Mandating GAAP Accounting is Costly and Counterproductive to Prudential Regulation

For State Farm Mutual, the most significant, costly and obvious example of a regulatory mismatch in the proposed rules is the apparent requirement that all insurance-based SLHCs utilize GAAP in preparing financial statements and in the reporting of data to the Board. As a mutual insurance company, State Farm Mutual is not required to and does not prepare GAAP financial statements. Instead, it prepares its financial statements using SAP, the state-mandated accounting system utilized by all insurance companies in the United States. Mandating GAAP would take several years to implement and be extremely costly–both in terms of financial resources and the burden of taking management time away from business operations. Moreover, our use of GAAP accounting would not provide the Board meaningful new information about the financial condition and capital strength of State Farm Mutual.

To the extent GAAP reporting provides any limited new information to the Board, the benefits of this information would be vastly outweighed by the costs of instituting GAAP and producing

duplicative financial statements. A recent study performed on behalf of State Farm Mutual and its subsidiaries indicated it would require a multi-year effort – exceeding four years – to implement a consolidated GAAP and regulatory reporting process. The estimated costs could approach $150 million initially with millions of dollars to maintain it annually. Moreover, the effort just to implement an automated regulatory reporting process – even without converting to GAAP – was estimated to take at least 12 months. Such time, effort and cost cannot be overlooked – or justified – especially when a time-tested and proven regulatory solvency framework is already in place for functionally regulated insurers like State Farm Mutual and no cogent analysis has been presented as to why such a framework falls short of congressional goals and directives. The bottom line is that SAP and the insurance RBC regime provide a much clearer and more insightful picture of the capital adequacy and financial condition of an enterprise where the overwhelming portion of its assets is held by an insurer(s).

As the National Association of Mutual Insurance Companies has explained: "The use of SAP is codified in all states because its more conservative approach in assessing an insurance company's solvency and ability to pay claims, and meet its obligations is the very foundation of financial entity regulation." SAP has a long history of highly effective use in the insurance sector and is well recognized within the accounting profession as an Other Comprehensive Basis of Accounting and, like GAAP, allows for audited financial statements.

Finally, the Board should not ignore that the sufficiency of SAP was clearly recognized by Congress as an acceptable accounting measure for insurance-based SLHCs in its consideration of the Dodd-Frank Act, as well as the Board's similar acceptance of reporting from foreign entities utilizing different accounting systems.

The Board Should Accept its Own Staff's Determination that Bank Rules are Inappropriate for Insurance

In 2002, in connection with the creation of financial holding companies under the Gramm-Leach-Bliley Act, members of the Board staff coauthored a report with the National Association of Insurance Commissioners (the "NAIC") in which they found that significant difficulties exist in reconciling the capital approaches used by bank regulators and those used by insurance regulators, particularly given that "the two frameworks differ fundamentally in the risks they are designed to assess, as well as in their treatments of certain risks that might appear to be common to both sectors." The report stated:

> Banking and insurance industry supervisors use very different approaches for identifying and addressing exposure to risks and losses, and to setting regulatory capital charges. The divergent approaches arise from fundamental differences between the two industries, including the types of primary risk they manage, the tools they use to measure and manage those risks, and the general time horizons associated with exposures from their primary activities.

The report concluded, "the effective regulatory capital requirements for assets, liabilities and various business risks for insurers are not the same as those for banks. . . . [T]he effective capital charges cannot be harmonized simply by changing the nominal capital charges on individual assets." Thus, the staff of the Board recognized at least as early as 2002 that bank-oriented capital rules are not appropriate for insurance companies. Not only has nothing changed since

2002 that would alter this conclusion, but the Board specifically stated in its early Dodd-Frank Act capital rule releases concerning SLHCs that it would "to the extent reasonable and feasible tak[e] into consideration the unique characteristics of SLHCs and the requirements of HOLA."

AIG Does Not Justify Establishing Inappropriate and Counterproductive Standards for Insurance-Based SLHCs

On numerous occasions the Board's senior leadership and staff have indicated to the insurance industry and Congress that the Basel framework is required for insurance companies in order to avoid another AIG and the need for a taxpayer bailout. As a substantive regulatory matter, however, this is truly a non-sequitur. Top-tier insurance-based holding companies like State Farm Mutual are subject to state holding company statutes that impose strict oversight of affiliate transactions, which substantially restrict a company's ability to engage in regulatory arbitrage. In contrast, AIG's holding company was not a functionally regulated insurance company and the lack of effective supervisory oversight of holding company activities and risk management practices across that enterprise was central to the company's overall liquidity crisis in 2008. Moreover, nothing that occurred at AIG, including the difficulties experienced in its securities lending program, warrants or justifies imposing a regulatory regime that does not match the business model and economic reality of the SLHC being regulated and that could actually weaken the SLHC.

The Collins Amendment Does Not Mandate Using the Basel Framework for Insurance Companies

Under Section 171 of the Dodd-Frank Act, commonly known as the Collins Amendment, the Board is required to establish minimum leverage capital requirements and minimum risk-based capital requirements, each to be met on a consolidated basis by depository institutions and their holding companies, including SLHCs. As stated in the statute, these requirements "shall not be less than the generally applicable leverage [and risk-based] capital requirements" that were in effect for insured depository institutions as of the date of enactment of the Dodd-Frank Act (i.e., July 21, 2010).

Although Section 171 requires the Board to set minimum capital requirements for depository institution holding companies, it does not preclude the Board from taking into account the existing and comprehensive RBC structure of insurance-based SLHCs in establishing these minimum capital requirements. Nor does anything in the Dodd-Frank Act as a whole suggest any such limitation. The statute does not, for example, require the Board to impose capital requirements based on GAAP rather than SAP (see further discussion below). Nor does Section 171 or any other part of the Dodd-Frank Act otherwise preclude the Board from designing capital standards that otherwise reflect appropriately fundamental differences between insurance SLHCs and other types of institutions so long as those requirements meet the statutory floor.

To the contrary, Congress recognized and preserved in the Dodd-Frank Act, in numerous ways, the "functional" regulation of "grandfathered" SLHCs that was an important aspect of the Gramm-Leach-Bliley Act. In so doing, Congress made clear that the implementation of Section 171 should be accomplished in a manner that accords appropriate treatment to the distinct nature of particular types of SLHCs, the distinct types of products and services they offer, and the comprehensive regulatory environment in which they operate. Indeed, in a letter sent this past

Monday to federal banking regulators, Senator Collins of Maine expressed her view that "it was not Congress's intent that federal regulators supplant prudential state-based insurance regulation with a bank-centric capital regime." She added that recognizing the distinctions between banking and insurance was consistent with her amendment.

Any Basel type regulation is not only inconsistent with evaluating insurance risks, but may, and likely will, produce dramatically wrong results. Inflexible adherence to a Basel I benchmark that is in direct conflict with economic reality should not be considered consistent with congressional intent in setting a floor for capital and leverage requirements. Therefore, in cases where the SLHC is engaged predominantly in the business of insurance and the holding company is a functionally regulated, operating insurer, we submit that the incorporating insurance RBC methodology is in fact the most reasonable interpretation of this floor and should be used for such purpose. Again, the issue is not about whether strong capital standards should be required—everyone shares that objective. The issue is about using the most appropriate and effective standards.

The Collins Amendment and the McCarran-Ferguson Act

Congress's intent regarding the application of the Collins Amendment to insurance company SLHCs whose subsidiaries are also engaged primarily in the business of insurance also must be construed against the background of the McCarran-Ferguson Act of 1945, in which Congress explicitly codified the primacy of the states in regulating the business of insurance. Specifically, the McCarran-Ferguson Act provides that no act of Congress, unless it "specifically relates to the business of insurance," shall be construed in a manner that would effectively "invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance."

Under the Supreme Court's decisions interpreting the McCarran-Ferguson Act, it does not appear that the Collins Amendment specifically relates to the business of insurance. The business of insurance is not expressly mentioned in the provision and nothing in its legislative history suggests that Congress specifically contemplated insurance companies in the Amendment. Furthermore, state insurance laws, including state insurance RBC requirements, clearly were enacted for the purpose of regulating the business of insurance. Consequently, any federal rules that fail to take into account state insurance RBC requirements threaten to impair the solvency laws enacted by the States for the purposes of regulating the business of insurance. They do this by adversely impacting the effective functioning of the business according to the well-established principles and practices that insurance companies would otherwise undertake in accordance with State insurance law requirements. Without a clearly expressed Congressional directive, the proposed rules run the risk of legal challenges under the McCarran-Ferguson Act.

The Proposals' Implications for Insurance-Based SLHCs, their Customers, and the Markets they Serve

If the Board persists in insisting upon bank-oriented rules that are inappropriate for insurance-based SLHCs, it is hard to avoid the conclusion some have offered that the proposed rules are the latest step toward the back door elimination of the thrift charter and grandfathered unitary SLHCs. For many such SLHCs, the Proposals would make operating a diversified SLHC, particularly one in which the savings bank subsidiary is a small part of the organization,

prohibitively expensive and subjected to managing to two different capital regulatory regimes, including one that is fundamentally inappropriate. Indeed, even the prospect of the adoption of the proposed rules has contributed to the decision of several insurance-based SLHCs to divest or convert their savings banks to non-depository trusts in order to avoid the expense and regulatory burdens potentially associated with SLHC status.

Congress, however, specifically preserved the thrift charter, SLHCs – and in particular grandfathered SLHCs – and functional regulation in the Dodd-Frank Act. The proposed rules effectively defy that Congressional determination, purportedly to achieve Congress's goals for capital adequacy, but apparently without consideration for how those goals can be met through measures wholly consistent with functional regulation. This regulation, as we have emphasized, relies on a comprehensive, long-standing RBC system that has served the insurance industry and consumers extremely well. The current proposed rules do not improve supervision over the financial strength of the insurance industry or the thrift industry; they detract from it.

A New Proposed Rule is Needed for Insurance-Based SLHCs

The simplest approach to addressing these issues and remaining faithful to Congress's objective to maintaining state functional regulation of insurance companies would be to incorporate state-based, capital, accounting, and reporting rules in the Proposals. However, given the lack of meaningful consideration for insurance-based SLHCs in the Proposals, we believe the Board should go back to the drawing board with respect to insurance-based SLHCs such as State Farm Mutual and develop a new proposed rule for public comment.

In developing a new proposed rule, we urge the Board to consult with the Secretary of the Treasury in obtaining the advice and assistance of the Federal Insurance Office (the "FIO"). We also request the Board to work with the insurance experts on the Financial Stability Oversight Council (the "FSOC), the NAIC, and industry members such as State Farm Mutual. We are confident that, in working in a collaborative manner with these insurance experts, the Board can develop a set of regulations that recognize and build upon the existing RBC structure in which insurance-based SLHCs operate. This will result in the development of a set of guidelines that will provide the Board with a more complete and insightful window into the capital adequacy and financial condition of the insurance-dominated SLHCs.

Conclusion

The Board's emphasis on applying bank-centric regulations to insurance companies creates a regulatory anomaly whereby rules intended to make holding companies financially stronger may compel behavior that weakens the capital strength of insurance-based SLHCs. In essence, the rules designed to fix problems in one industry (i.e., banking) wreak harm if applied to another industry. Such misplaced application is not what Congress had in mind in the Dodd-Frank Act. Furthermore, the Proposals appear inconsistent with the McCarran-Ferguson Act's approach to regulating the business of insurance.

There are a number of alternatives the Board could apply to correct this problem, including modifying the Proposals to accept state-based capital requirements for insurers. Consequently, we strongly urge the Board to withdraw the proposed rules as applied to insurance-based SLHCs and to work together with the insurance experts within the FIO, FSOC, and other entities in the

federal government, as well as the state insurance regulators and the insurance industry to develop a new set of proposed rules designed specifically to achieve Congress's intent for a strong and competitive financial system that effectively delivers high-quality services to consumers within the context of functional regulation of financial institutions.

Again, we are not seeking weak capital rules or special exemptions—just rules that make sense.

Thank you.

Hearing before the Committee on House Financial Services
Subcommittees on Financial Institutions and Consumer Credit, and Insurance, Housing and Community Opportunity

Examining the Impact of the Proposed Rules to Implement Basel III Capital Standards

November 29, 2012

Statement of Gina Wilson
Executive Vice President & Chief Financial Officer
TIAA-CREF

I. Introduction

Chairwoman Biggert, Chairwoman Capito, Ranking Members Gutierrez and Maloney, Members of the Subcommittees, thank you for providing TIAA-CREF with the opportunity to testify on this very important issue before the Subcommittee on Insurance, Housing and Community Opportunity, and the Subcommittee on Financial Institutions and Consumer Credit.

Our testimony today will focus on the regulatory capital proposals (the "Proposals") issued on June 7, 2012, by the Federal Reserve Board ("FRB") in conjunction with the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC") (collectively the "Agencies").[1] These proposed rules are designed to implement the capital reforms outlined in Basel III and the required changes to capital standards mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "DFA").

II. Background

TIAA-CREF is a leading provider of retirement services in the academic, research, medical and cultural fields managing retirement assets on behalf of 3.7 million clients at more than 15,000 institutions nationwide. The mission of TIAA-CREF is "to aid and strengthen" the institutions we serve by providing financial products that best meet the needs of these organizations and help their employees attain financial well-being. Our retirement plans offer a range of options to help individuals and institutions meet their retirement plan administration and savings goals as well as income and wealth protection needs.

TIAA-CREF is comprised of several distinct corporate entities. Teachers Insurance and Annuity Association of America ("TIAA"), founded in 1918, is a life insurance company domiciled in the State of New York operating on a non-profit basis with net admitted general account assets of $216.8 billion.[2] TIAA is a wholly-owned subsidiary of the TIAA Board of Overseers, a special purpose New York not-for-profit corporation. The College Retirement Equities Fund ("CREF") issues variable annuities and is an investment company registered with the Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940. TIAA-CREF also sponsors a family of equity and fixed-income mutual funds.

While we are primarily engaged in the business of insurance, TIAA and the Board of Overseers hold a small thrift institution within their structure and as a result are registered as a Savings and Loan Holding Company ("SLHC"). This thrift provides TIAA-CREF with the ability to offer our clients deposit and lending products integrated with our retirement, investment management and life insurance products and enhances our ability to help them attain lifelong financial well-being.

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[1] 77 F.R. 52,792 (Aug. 30, 2012); 77 F.R. 52,888 (Aug. 30, 2012); 77 F.R. 52,978 (Aug. 30, 2012).
[2] As of September 30, 2012.

Our status as a SLHC places us under the purview of the FRB and consequently subjects us to the proposed regulatory capital regime the Agencies have set forth. TIAA-CREF supports the ongoing financial regulatory reform efforts and believes establishing a strong set of capital rules is essential to supporting a banking organization's investment and risk management goals. It is equally important, however, to ensure the standards ultimately implemented by the Agencies fully account for the diverse business models under which different financial services organizations operate. In our analysis of the Proposals through the prism of a firm predominantly engaged in insurance, we have found the Agencies have taken a decidedly bank-centric approach. Consequently, this approach does not account for the vast differences between insurers who hold thrifts but maintain the overwhelming majority of their business in insurance products ("Insurance-centric SLHCs"), and those firms that are primarily banking entities.

We would like to reiterate our support for and understanding of the need for appropriate capital regulations for banking organizations and emphasize that we are not seeking to exempt insurers from the Proposals. Nevertheless, applying standards designed for banks to an insurer would be inappropriate and could have a number of negative effects for insurers, customers and the economy as a whole. TIAA-CREF as an organization is particularly concerned about the effects of the proposals on our ability to continue providing our clients with a full menu of high quality, reasonably priced financial services products.[3]

We have identified a number of our concerns with the Proposals and discuss them in detail in our comment letter, which is attached for your reference (see Appendix A). Our testimony, however, will focus on two specific items that we consider the core of our comments and the key to resolving most of the potential repercussions that would go along with imposing a bank-focused capital regime on insurance companies.

First, we will discuss congressional intent and Section 171 of the DFA, commonly known as the Collins Amendment. The FRB has taken the position that the Collins Amendment, which requires regulators to establish risk-based capital standards for banking organizations, prohibits the FRB from treating insurance assets differently from banking assets. We believe, however, that the Collins Amendment does provide banking regulators with the necessary flexibility to account for and integrate the existing insurance regulatory capital regime when developing their new model.

Second, we will outline two alternative approaches to addressing insurance activities that could be integrated into the proposed framework. Each approach utilizes the existing insurance regulatory capital standards for insurance activities. Adopting either of these alternatives would ensure Insurance-centric SLHCs continue to adhere to a robust set of capital standards tailored to the risks of their business model while also remaining in line with the FRB's micro and macro prudential supervisory goals of

[3] We believe, in this respect, that it is important the Agencies conduct a thorough cost-benefit analysis to determine the effects of the Proposal on insurers and other organizations that would be subject to the enhanced capital standards.

improving safety and soundness of financial institutions and reducing systemic risk for the overall economy.

III. Congressional Intent and the Collins Amendment

We believe Congress clearly demonstrated throughout the DFA legislative process, and in the text of various provisions within DFA, its intent to allow Insurance-centric SLHCs to continue to own thrifts and offer their customers banking products and services. During the DFA legislative process, Congress affirmed the importance of the SLHC structure by maintaining the thrift charter, ensuring SLHCs would not need to become Bank Holding Companies ("BHCs"), and maintaining the Gramm-Leach-Bliley ("GLB") grandfather provisions for nonbank activities of certain SLHCs and the qualified thrift lender ("QTL") test for SLHCs. Congress went so far as to instruct "the Federal Reserve [to] take into account the regulatory accounting practices and procedures applicable to, and capital structure of, holding companies that are insurance companies (including mutuals and fraternals), or have subsidiaries that are insurance companies" in determining SLHC capital standards.[4] Indeed, as demonstrated by the Volcker Rule insurance exemption, Congress expected insurance companies to continue to own thrifts.[5] By taking these steps, Congress also confirmed that the public is entitled to more, not less, competition in the banking industry. Unfortunately, the current Proposals would make continued ownership of thrifts by insurance organizations economically prohibitive and could effectively accomplish through regulation what Congress not only did not intend to do by statute,[6] but what it specifically directed the FRB to avoid doing.

The Collins Amendment requires banking regulators to establish minimum risk-based and leverage capital requirements on a consolidated basis for insured depository institutions, depository institution holding companies and nonbank financial companies supervised by the FRB (collectively, "Covered Companies"). However, nowhere in the language of the Collins Amendment is found a directive to ignore the differences between insurance companies and banks. Rather, the language only requires that the risk-based and leverage capital requirements applicable to covered companies shall not be:

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[4] Senate Report 111-176 at footnote 161 (April 30, 2010) – discussion of Section 616 amending HOLA to clarify the FRB's authority to issue capital regulations for SLHCs where the Committee specifically notes:

> It is the intent of the Committee that in issuing regulations relating to capital requirements of bank holding companies and savings and loan holding companies under this section, the Federal Reserve should take into account the regulatory accounting practices and procedures applicable to, and **capital structure of, holding companies that are insurance companies (including mutuals and fraternals)**, or have subsidiaries that are insurance companies. " [emphasis added].

[5] Section 619(d)(1)(F) of the DFA.

[6] "Dodd-Frank amps insurers for banking exit," SNL Financial (July 11, 2012).

i. Less than the generally applicable risk-based capital and leverage capital requirements, which shall serve as a floor for any capital requirements that the Agencies may require ("Bank Standard"); or

ii. Quantitatively lower than the generally applicable risk-based capital and leverage capital requirements that were in effect for insured depository institutions as of the date of enactment of the DFA ("2010 Regulations").[7]

We do not believe the Collins Amendment intended that the banking regulators ignore the differences between banks and insurance companies in formulating the Bank Standard nor for the standards applicable to other Covered Companies. Rather, we believe the Bank Standard outlined in Section 171(a)(2) of the Collins Amendment, which sets a floor for SLHC risk-based capital standards, allows the FRB to specifically address insurance activities as the Proposals do for policy loans, separate accounts, or, as recommended, more holistically through an insurance deduction or alternative risk asset calculation. The requirement of Section 171(b)(2) setting the "generally applicable risk-based capital requirements" floor does not require an asset-by-asset testing of risk-weights, but instead speaks to a "numerator" of capital, a "denominator" of risk-weighted assets and a ratio of the two. The Collins Amendment does not require asset-by-asset or exposure-by-exposure minimum requirements, but instead calls for holistic floors. The second requirement that the standards not be quantitatively lower than the 2010 Regulations can be satisfied by either following the terms of the 2010 Regulations or through a holistic quantitative analysis of equivalence, which we believe would meet the "not less than" language of the statute.

The FRB apparently does not share this view of the Collins Amendment. Instead, they believe the language gives them a mandate to implement a consistent set of asset specific risk-weights for all covered companies.[8] We have expressed to the FRB, both in person and in our comment letter, our view that the language of the Collins Amendment provides adequate flexibility to interpret the statute in a way that would allow them to account for the differences between banking and insurance. We believe the Agencies should modify the Proposals to recognize that the business of insurance has different economic characteristics and serves different economic purposes than the business of banking and, accordingly, Insurance-centric SLHCs should be measured through capital standards designed to create appropriate incentives and standards for the business of insurance.

IV. Equivalency and Calibration Alternatives

We have developed two alternative solutions that would allow the FRB to implement a consolidated risk-based capital regime that utilizes the existing insurance

[7] Section 171(b)(1) of the DFA.

[8] U.S. Senate Committee on Banking, Housing and Urban Affairs, "Oversight of Basel III: Impact of Proposed Capital Rules," Statement of Michael S. Gibson, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, November 14, 2012.

capital standards and still meets the requirements that these standards not be "less than" or "quantitatively lower than" the bank risk-based and leverage capital requirements referenced in the Collins Amendment. We strongly support the use of either of these equivalency and calibration approaches for addressing how to incorporate insurance activities into the risk-based capital rules for Insurance-centric SLHCs. We believe the existing National Association of Insurance Commissioners ("NAIC") insurance company risk-based capital framework utilized by insurance supervisors ("NAIC RBC") accounts for the types of risks inherent in insurance, whereas the proposed bank-centric capital standards do not. NAIC RBC is a comprehensive capital regime for insurance activities that should be viewed as equivalent to the Basel regime of bank risk-based capital in comprehensively addressing on- and off-balance sheet risk. Through calibration of required capital, NAIC RBC can be incorporated into a consolidated risk-based capital requirement for Insurance-centric SLHCs. We believe the Agencies should strongly consider the two alternatives to calibrating and incorporating NAIC RBC into the Proposals to better reflect the treatment of insurance activities.

A. Deduction and Calibration Alternative

The first alternative is to follow the approach agreed to in Basel II and Basel III and deduct both the capital and assets of insurance subsidiaries. The FRB could then hold these insurance subsidiaries to a prudent level of capital in excess of insurance regulatory minimums with such a standard measured in terms of NAIC RBC. This approach would be consistent with the "not quantitatively less than" requirement of the Collins Amendment, since under the 2010 Regulations, each Agency reserved the right at its discretion to deduct the capital and assets of any subsidiary from the calculation of bank level risk-based capital.[9] Likewise, the "not less than" test of the Collins Amendment would be satisfied by applying this deduction equally to both bank- and holding company-owned insurance company subsidiaries. The resulting standard would remain "on a consolidated basis" because the capital deduction would be part of the numerator calculation and the asset deduction would be part of the denominator calculation for determining a SLHC's capital ratios. Such an approach is identical to the treatment for other assets deducted from consolidated capital under the Proposals and still satisfies the "consolidated basis" standard of the Collins Amendment.[10] On a preliminary basis, we believe setting an NAIC RBC ratio of 300% as equivalent to the well-capitalized ratios required for banks is appropriate.

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[9] See 12 C.F.R. Part 208 Appendix A, Section II.B.ii. (FRB Regulation H); 12 C.F.R. Part 3, Appendix A, Section 2(c)(7)(i) ("*Deductions from total capital.* The following assets are deducted from total capital: (i) Investments, both equity and debt, in unconsolidated banking and finance subsidiaries that are deemed to be capital of the subsidiary; and [t]he OCC may require deduction of investments in other subsidiaries and associated companies, on a case-by-case basis"); 12 C.F.R Part 325, Appendix A, Section II.B.3. (FDIC regulations) ("FDIC may also consider deducting investments in other subsidiaries, either on a case-by-case basis or, as with securities subsidiaries, based on the general characteristics or functional nature of the subsidiaries.").

[10] See §_____.22 Regulatory capital adjustments and deductions generally deducting items from Tier 1 common equity and subsection (f) treatment of assets that are deducted – "A [BANK] need not include in risk-weighted assets any asset that is deducted from regulatory capital under this section." 77 F.R. at 52,863 (Aug. 30, 2012).

B. Conversion and Calibration Alternative

The second alternative was proposed by the ACLI in its comment letter to the Agencies dated October 12, 2012.[11] Under this approach, regulators would use NAIC RBC to calculate risk-assets to be included in the SLHC's risk-based capital calculations. This approach incorporates NAIC RBC into the Basel-based rules in a manner that avoids the misalignment of the incentives for managing insurance activities through a quantitative calibration of insurance capital requirements with and into the Basel requirements. Thus, it maintains the numerators of Tier 1 common equity, Tier 1 capital and total capital, and through a calibrated conversion process calculates risk-weighted assets for the denominator and the capital ratio calculations.

Under each of these approaches, only activities conducted under an insurance company would be subject to NAIC RBC. Any non-insurance subsidiary of a SLHC that is not also an insurance company would be subject to Basel capital standards. Likewise, the activities of the thrift subsidiary would remain subject to Basel capital standards. In combination, all activities would be subject to consolidated capital requirements. A non-insurance subsidiary of a non-insurance company SLHC would be subject to the Basel risk-weighting and consolidated capital requirements under these approaches. Additionally, the consolidated leverage ratio requirement of holding 4% Tier 1 capital to average total assets would continue to set a universal capital floor for all SLHC activities, including those conducted through insurance companies.

C. Regulatory Arbitrage Concerns

Because we recognize the FRB's historic concerns regarding regulatory arbitrage, we think it is important to note neither of the approaches would allow businesses predominantly engaged in banking to park assets with insurance affiliates in order to lower their consolidated capital requirements. Either alternative could be tailored to apply to organizations primarily engaged in the business of insurance and then only for activities of regulated insurance companies. In addition, these approaches could include a provision allowing the Agencies the discretion to apply the general bank risk-weights to insurance company assets on a case-by-case basis in order to counter identified cases of regulatory arbitrage.

Further, we do not believe any organization not already an insurer would have an incentive to become primarily engaged in the insurance business in order to take advantage of the differing capital treatment of individual assets under NAIC RBC and the Basel capital standards. Indeed, regulatory arbitrage between these two standards cannot be eliminated for the financial system as a whole unless all regulated and unregulated financial institutions are subjected to a single integrated capital standard. In this regard, we are concerned insurance companies not subject to FRB oversight will set the market price for insurance products and the additional capital and other costs imposed by FRB

[11] See Appendix AA to the ACLI's letter.

oversight will make insurance products offered by SLHC-affiliated insurance companies non-competitive.

V. Conclusion

The proposed capital standards set forth by the Agencies as drafted would have a detrimental effect on insurers' ability to offer affordable financial products, which would in turn trickle down to individuals who utilize insurance products to help them build a more secure financial future. The proposals also could have macroeconomic implications that, for example, would create disincentives for insurers to invest in asset classes that promote long-term economic growth such as long-term corporate bonds, project finance and infrastructure investments, commercial real estate loans and alternative asset classes such as timber.

Strong capital standards are vital to strengthening the overall structure of the U.S. financial system. The existing capital regime under which insurers operate has served the industry well and proved extremely effective when put to the test during the recent financial crisis. We are confident the alternative proposals we have outlined would allow the Agencies to establish a strong capital regime that also accounts for the business of insurance. We hope that as they continue to analyze the comments they have received, regulators will find our alternative approaches offer a sensible way to integrate into their proposed capital structure an alternative designed for insurers.

Thank you again for the opportunity to testify. Given the potential affect the Proposals could have on our business and our clients, we have been very active in our efforts to educate policy makers about our concerns and will continue to leverage all opportunities made available to us. We appreciate that the Subcommittees have taken an interest in this issue and have afforded us another venue in which to discuss our concerns.

APPENDIX A



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October 22, 2012

The Honorable Thomas J. Curry
Comptroller
Department of the Treasury
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250 E Street, S.W.
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The Honorable Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW.
Washington, DC 20551

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
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Re: Regulatory Capital Rules

Dear Sirs:

TIAA-CREF appreciates the opportunity to comment on the three notices of proposed rulemaking ("Proposals") issued on June 7, 2012, by the Board of Governors of the Federal Reserve System ("FRB"), the Office of the Comptroller of the Currency ("OCC"), and the Federal Deposit Insurance Corporation ("FDIC") (collectively, the "Agencies").[1] We believe the Proposals have created a devil's dilemma for insurance-based holding companies such as ourselves. Because the Proposals do not effectively recognize the long-dated nature of both sides of an insurance company's balance sheet, the requirements of the Proposals will force insurance companies to carry excess capital as well as restructure their balance sheets and fundamental investment activities. Alternatively, they will force insurance companies (as many already have) to exit the banking business. Each of these results is detrimental to individuals, the industry and the economy at large. If, on one hand, an insurance company chooses to restructure its balance

[1] 77 F.R. 52,792 (Aug. 30, 2012); 77 F.R. 52,888 (Aug. 30, 2012); 77 F.R. 52,978 (Aug. 30, 2012).

sheet and fundamental investment activities to meet the Proposals' standards, it will both become less competitive with non-bank affiliated insurance companies and may be forced to invest in a manner inconsistent with its long-term obligations. If, on the other hand, an insurance company exits banking, it will further contribute to the increasing concentration of banking activities in a few systemically significant firms and simultaneously deprive consumers of the choice of obtaining banking services from a trusted financial services organization. This dilemma is unnecessary. A reasonable capital regime, coupled with FRB oversight at the holding company level, can address both the prudential and systemic risk concerns the Agencies intended to satisfy through the Proposals without creating this dilemma. We set forth below how, by incorporating existing insurance regulatory requirements, the Agencies can ensure adequate capital at the holding company level without disrupting the business of insurance and the availability of long-term credit, while preserving consumer choice.

TIAA-CREF supports a robust and comprehensive regulatory regime for the financial services sector. Accordingly, we support the efforts of regulators to boost the strength of financial institutions through improving oversight and increasing safety and soundness of such organizations, especially considering the events that unfolded during the 2008 global financial crisis. The crisis tested the strength and resiliency of our financial system and the economy as a whole and it is our hope that the lessons learned will help ensure that when the United States experiences another period of extreme economic stress, the changes made to the regulatory structure will ensure the financial system will be better able to withstand such adverse conditions.

While we understand the need for reforming the current financial system and the important role the Agencies' proposed rules around capital standards play in these efforts, we have identified several areas within the Proposals with which we have concerns. Our overarching concern relates to the approach the Agencies have taken to applying enhanced capital standards to Savings and Loan Holding Companies ("SLHCs") predominantly engaged in the business of insurance ("Insurance-centric SLHCs") and the approach to the business of insurance generally.

The Proposals as drafted would impose a bank-centric consolidated capital regime on Insurance-centric SLHCs. A strong capital regime for banking organizations is vital, but it is equally important to ensure that the Agencies consider an organization's primary line of business when implementing these standards. The business of banking and the business of insurance have a common goal of helping individuals attain important financials milestones. Nevertheless, they each operate under distinct and separate business models that allow them to address different aspects of an individual's financial needs (e.g., long-term vs. short-term financial goals). Applying capital standards that have been developed for banks to the entire enterprise of an organization primarily engaged in insurance could, in short, result in an insurer having to change the model under which it operates, ultimately having a significant affect on those who depend on insurance products for their financial security and the economy as a whole.

We support the steps being taken to ensure that banking institutions are well-capitalized and better able to weather future economic crises. Establishing a strong capital regime that is consistent with safety and soundness and appropriately considers risk is necessary for the continued success of our financial system and the overall health of our economy. We appreciate

that in drafting the Proposals the Agencies took steps to consider carefully the potential affects these enhanced standards could have on all banking organizations and accordingly sought to "minimize the potential burden of these changes where consistent with applicable law and the agencies' goals of establishing a robust and comprehensive capital framework."[2] Nevertheless, as an insurer that would come under the new capital structure because of our SLHC status, we believe that there are several issues the Agencies should consider before moving forward with a final rule. In the sections that follow, we will outline our concerns and highlight the important considerations that must be made to ensure that Insurance-centric SLHCs can continue to conduct business in a prudent manner, while still adhering to a robust set of standards that will ensure such organizations are financially healthy and well-capitalized.

I. Background

TIAA-CREF is a leading provider of retirement services in the academic, research, medical and cultural fields managing retirement assets on behalf of 3.7 million clients at more than 15,000 institutions nationwide. The mission of TIAA-CREF is "to aid and strengthen" the institutions we serve by providing financial products that best meet the needs of these organizations and help their employees attain financial well-being. Our retirement plans offer a range of options to help individuals and institutions meet their retirement plan administration and savings goals as well as income and wealth protection needs.

TIAA-CREF is comprised of several distinct corporate entities. Teachers Insurance and Annuity Association of America ("TIAA") was founded in 1918 and is a life insurance company domiciled in the State of New York operating on a non-profit basis with net admitted general account assets of $213.9 billion.[3] TIAA is a wholly-owned subsidiary of the TIAA Board of Overseers, a special purpose New York not-for-profit corporation. The College Retirement Equity Fund ("CREF") issues variable annuities and is an investment company registered with the Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940. TIAA-CREF also sponsors a family of equity and fixed-income mutual funds.

Based on their indirect ownership of TIAA-CREF Trust Company, FSB ("TIAA-FSB"), TIAA and the TIAA Board of Overseers are registered as SLHCs under the Home Owners' Loan Act ("HOLA"). TIAA-FSB provides TIAA-CREF with the ability to offer our clients deposit and lending products integrated with our retirement, investment management and life insurance products in a manner that enhances our ability to help them attain the aforementioned goal of lifelong financial security. TIAA's ownership of TIAA-FSB has made all of our activities potentially subject to the bank-centric consolidated capital standards outlined in the Proposals. For the reasons discussed below, we are concerned that, unless modified, the Proposals will restrict our ability to make long-term investments on behalf of our clients, will unduly reduce our competitiveness and will reduce the availability of long-term credit for many sectors of the U.S.

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[2] 77 F.R. at 52,795-6 (Aug. 30, 2012).

[3] As of June 30, 2012.

economy. Moreover, such an outcome can be avoided by incorporating appropriate standards for insurance activities into the Proposals. Throughout our letter, we will highlight our chief concerns with the Proposals and explain why it is not appropriate for the FRB to impose bank-centric capital standards on insurers.

II. The business of insurance differs fundamentally from banking and this has significant public policy implications

A. Fundamental differences

As we have stated in our prior letters to the FRB and the Financial Stability Oversight Council ("FSOC"), the business of insurance differs fundamentally from other areas of the financial services sector.[4] Insurance products allow consumers to transfer risk through products such as life insurance (the risk of dying too soon) and annuities (the risk of outliving retirement savings), as opposed to taking on greater risk, as is often the case with other financial products such as stocks (market risk) and bonds (interest rate risk). Retirement and life insurance products generally require that policyholders pay premiums in exchange for a legal promise that is often finally settled years in the future. In addition, insurance liabilities tend to operate independent of the business cycle in that they are predetermined (e.g., annuities, term life) or randomly dispersed (e.g., natural disasters) and thus the payout schedule is not a function of economic conditions. Unlike banks, insurers' stable liabilities provide them far greater freedom to choose when to sell assets, and they are unlikely to be forced to liquidate assets to satisfy short-term obligations in times of economic difficulty or market disruption, as is common among traditional banking entities.[5]

TIAA-CREF believes that the Proposals' failure to take into account the fundamental differences between insurance and banking will harm the macro-economy as well as the insurance industry, thereby hindering the FRB and FSOC in their efforts to promote financial stability and economic growth. Because the Basel capital framework focuses substantially on assets (rather than a more holistic approach that recognizes the value of stable liabilities or financing concerns), the Proposals do not consider the importance of matching duration of assets and liabilities on an

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[4] See TIAA-CREF Letters available at: http://www.federalreserve.gov/SECRS/2011/November/20111116/ICP-201114/ICP-201114_110111_88449_343583382755_1.pdf; http://www.federalreserve.gov/SECRS/2012/May/20120517/R-1438/R-1438_043012_107245_506832527948_1.pdf; http://www.federalreserve.gov/SECRS/2011/April/20110413/ICP-201102/ICP-201102_041111_69324_570978081157_1.pdf; and http://www.federalreserve.gov/SECRS/2011/June/20110609/OP-1416/OP-1416_052311_73348_509124981536_1.pdf.

[5] This strength is particularly evident in periods of market disruption or with regard to less liquid assets where insurance companies do not contribute to the downward pressure on asset prices created by the short-term liquidity needs of other types of investors.

insurer's balance sheet. To ignore the fundamental importance of this concept is to ignore the most important element of insurer risk management.

The fundamental differences between insurance and banking have been addressed on multiple occasions by the International Association of Insurance Supervisors ("IAIS"). In its May 31, 2012 consultation document which proposed a methodology to assess the systemic risk of insurance companies, the IAIS stated, "insurers vary widely from banks in their structures and activities and consequently in the nature and degree of risks they pose to the global financial system."[6] The IAIS identified several differences between insurance and banking including: (a) insurers use a predominantly liability-driven investment approach; (b) insurance rests on the pooling of risks and probability theory; and (c) the nature of insurance claims result in cash outflows that are likely to occur over an extended period.[7] Importantly, the IAIS stated insurance underwriting risks generally are "not correlated with the economic business cycle. The nature of insurance liabilities, and the fact that payments to policyholders generally require the occurrence of an insured event, makes it less likely for insurers engaged in traditional activities to suffer sudden cash runs that would drain liquidity."[8]

For insurance companies, a key concern is solvency and the ability to pay policyholders over long periods. Premiums are collected in advance and invested ahead of anticipated claims, insurers have relative predictability of those claims, and products have safety mechanisms such as surrender charges to protect against early liquidity demands.[9] Unlike banks, which typically are funded by immediately payable deposits, insurers have longer-term liabilities and therefore find that longer-term assets, even those with higher short-term volatility, can often pose less risk and be a key component to the long-term viability and financial strength of an insurer. Corporate debt securities represent the largest component of life insurer assets, with life insurers holding approximately $1.7 trillion in fixed income securities at the end of 2010.[10] For insurance companies, in light of their defined liability structure, these substantial holdings of fixed income securities are risk-mitigating, rather than risk-enhancing.

Insurance companies maintain significant reserves against policyholder obligations that are taken into account in determining equity capital. Insurance companies generally do not have large

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[6] IAIS, Globally Systemic Important Insurers: Proposed Assessment Methodology, 11 (May 31, 2012) (www.iaisweb.org/view/element_href.cfm?src=1/15384.pdf) ("IAIS Report").

[7] Id. 8-9.

[8] Id. 8-9.

[9] In the case of TIAA, a majority of our annuity contracts only allow transfers out of the fixed annuity backed by TIAA's general account to other investment options over a period of several years.

[10] ACLI Investment Bulletin, "Invested assets portfolio profile year end 2011." (Aug. 2012) (data from NAIC annual statutory filings).

lending portfolios and thus do not maintain significant loan loss reserves.[11] Unless such differences are considered in calculating regulatory capital, the use of bank-centric standards will discourage conservative insurance company reserving in favor of maintaining bank-centric regulatory capital based on a regulatory model that does not consider the Insurance-centric SLHCs insurance activities and risks, an outcome that would have both negative safety and soundness and macro-prudential consequences. The existing National Association of Insurance Commissioners ("NAIC") insurance company risk-based capital framework utilized by insurance supervisors ("NAIC RBC") accounts for these types of risks, whereas bank-centric capital standards do not.

Bank-centric metrics will not provide regulators with the information they need regarding the capital and long-term solvency of Insurance-centric SLHCs. Indeed, we believe the application of bank-centric capital standards to the business of insurance is not relevant to either the FRB's macro-prudential responsibilities or its micro-prudential supervisory responsibilities for Insurance-centric SLHCs and will likely lead to unintended and inappropriate results. NAIC RBC and life insurance enterprise risk management focus on the solvency of the insurer and the matching of assets to liabilities over the long-term. Insurance regulators require insurers to conduct regular stress tests using conservative assumptions to test insurance company reserves in the context of insurers' long-term liabilities. Bank-centric metrics focus on short-term events and will not accurately reflect an insurer's solvency. More specifically, bank capital standards focus primarily on equity capital, not adequacy of reserves, and lending activities and related regulatory capital considerations.

NAIC RBC, along with other regulatory tools, has proven effective in limiting insolvencies and preserving financial strength, as was highlighted during the recent financial crisis. According to the FSOC's 2011 report, just 28 of approximately 8,000 insurers became insolvent in 2008 and 2009.[12]

B. Implications of differences

Business and risk model diversification is an important element in reducing systemic risk and actions that increase the correlation of different companies' business and risk models will tend to increase systemic risk.[13] By creating incentives that encourage synchronization of the banking

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[11] See footnote 35 below.

[12] FSOC, *2011* Annual Report, 61. The FSOC 2011 Annual Report (at 58) also states that: "as the crisis has unfolded, 370 bank and thrift failures occurred through June 30, 2011, or 4.5 percent of institutions operating at the beginning of 2008." During that same time 0.35% of insurers became insolvent.

[13] This was seen in the period leading up to the financial crisis as common business models relying on risk management models with common assumptions regarding the mortgage and securitization markets led to overly aggressive pricing and lending standards and as a consequence significantly higher losses and market disruption during the financial crisis. See International Monetary Fund, Chapter 3, The Reform Agenda: an interim report on progress toward a safer financial system. 5 (Oct. 2012) ("In a ***common pattern*** before and, in some cases, during the global crisis, banks used structured investments and proprietary trading to generate additional return ("alpha") at

and the insurance investment and risk management models, the Proposals will act to increase their correlation and will reduce systemic resiliency. At the same time, the incentives created by the Proposals act as a disincentive in the credit transmission mechanism, and for insurers specifically they create a disincentive to invest in a variety of asset classes that promote long-term economic growth such as long-term corporate bonds, project finance and infrastructure investments, commercial real estate loans and alternative asset classes such as timber. The presence of insurance companies traditionally has been greatest in the bond and mortgage markets. As demonstrated by the table and charts in Exhibit A, insurers are significant investors in these asset classes and types of investments and manage a sizable portion of all financial assets held by intermediaries in the United States. Further, economic research shows that these financial investments are correlated with increased economic activity and that shifts away from these investments will result in a reduction in credit allocation, long-term investment and economic growth.[14]

Similarly, withdrawal of Insurance-centric SLHCs from the business of banking would increase systemic risk and have negative consequences to the economy. Over the past several decades, consolidation in the banking sector has been rapid with the market share of the top ten banking organizations (as measured by total deposits) increasing from 29.8% in 2000 to 43.4% in 2008.[15] The financial crisis only has served to accelerate this trend with the top ten banking organizations now having over a 50% market share of total deposits and the top five organizations having a more than 41% share of total deposits.[16] The insurance sector represents one of the few industries that can provide new competition in banking services and financial intermediation, both directly and through thrift subsidiaries, and decrease systemic reliance on the five largest banking organizations. Such competition is one element of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA")'s approach for mitigating the "too big to fail" problem highlighted by the financial crisis.[17]

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the cost of a rise in "tail-risk" – the risk of rare but catastrophic events. A realization of such risk is likely to bring about long-lasting bank distress." [citations omitted, emphasis added]).

[14] King, Robert G. and Ross Levine, "Finance Entrepreneurship and Growth, Theory and Evidence," Journal of Monetary Economics, (Sept. 1993).

[15] Adams, Robert, "Consolidation and Merger Activity in the United States Banking Industry from 2000 through 2010," Finance and Economics Discussion Series, Division of Research & Statistics and Monetary Affairs, Federal Reserve Board. 22, Table 3 (Aug. 2012).

[16] American Banker, "Banks and Thrifts with the Most Deposits on March 31, 2012," American Banker website; and FDIC Quarterly Banking Profile Volume 6, No. 2, 5 (2012).

[17] See Section 622 of DFA and the analysis in the FSOC "Study & Recommendations Regarding Concentration Limits on Large Financial Companies," (Jan. 2011) (www.treasury.gov/initiatives/Documents/Study%20on%20Concentration%20Limits%20on%20Large%20Firms%2001-17-11.pdf).

History has shown that the insurance industry does not experience the same level of insolvencies as the banking industry. In comparing the financial condition of the U.S. banking system and the U.S. insurance industry, the fundamental differences in their structure, regulation and investment practices help to explain why they perform differently during cyclical downturns. As we have discussed, banks primarily manage short-term liabilities, whereas insurance companies primarily manage longer-term liabilities such as life policies and group annuities. This liability structure allows insurers to invest at fixed rates and not assume significant interest rate mismatch risk. This is very different from banks whose fundamental intermediation function is to collect short-term deposits from investors and lend these funds for a longer-term to borrowers.

Likewise, the very structure of the U.S. banking system and its focus on lending makes it very difficult for any but the few largest banks to diversify their investments by sector and geography and thereby lessen their vulnerability to regional economic cycles. Insurance companies affiliated with Insurance-centric SLHCs, by contrast, are national in scope and hold far more geographically diversified assets in all asset classes, from commercial and residential mortgage loans to corporate bonds. Banks not only are less geographically diversified than insurers, but they also concentrate their investments in fewer and historically higher-risk investment classes. For instance, whereas banks concentrate their lending in highly cyclical credit cards, auto and short-term real estate lending, insurers invest primarily in longer-term commercial mortgages granted on income-producing properties that are well leased and generally have high loan-to-value ratios. With this income and value cushion, the property value must deteriorate significantly before the insurer would suffer a loss. This difference in lending quality between insurers and banks is borne out by the relatively low delinquency rate on insurance company commercial mortgages, as compared to the much higher rate of delinquency experienced by banks. In another example, whereas banks aggressively pursued lending in highly leveraged transactions, insurers followed more conservative investment practices.

One important lesson insurers have learned from the widespread failures in the banking industry is the false security and even weakness caused by reliance on FDIC insurance of deposit funds, which muted the discipline and selection mechanisms of the market and burdened the public and the conservative, stronger banks with the task of bailing out the most aggressive failed banks. The consensus among insurers is that it is not healthy to rely on guaranty funds. In fact, it has been argued that it is the issue of "moral hazard" related to rising amounts of FDIC insurance per account and deregulating the industry that heavily contributed to the increase in risk-taking before the financial crisis. These are lessons that the insurance industry and its regulators have internalized and are reflected in their traditional practices and new rules made since the financial crisis.[18]

[18] Insurers have long been prohibited from advertising the existence of guaranty funds in contrast to banks being required to disclose their FDIC insurance on every advertisement. See N.Y. Ins Law § 7718 ("No person, including an insurer, agent or affiliate of an insurer and no broker shall make, publish, disseminate, circulate or place before the public, or cause directly or indirectly, to be made, published, disseminated, circulated or placed before the public, in any newspaper, magazine or other publication, or in the form of a notice, circular, pamphlet, letter or poster, or over any radio station or television station, or in any other way, any advertisement, announcement or statement which uses the existence of the corporation for the purpose of sales, solicitation or inducement to purchase any form of insurance") in contrast to 12 C.F.R. § 328.3(c) (each insured depository institution "shall include the official

III. Proposed timing for SLHCs to comply with new standards is insufficient

We share the concerns expressed by the Financial Services Roundtable, the American Council of Life Insurers ("ACLI") and other industry associations that the Proposals would require all SLHCs, regardless of size, to meet new minimum capital requirements beginning January 1, 2013.[19] Putting aside for the moment the numerous reasons why applying such metrics to Insurance-centric SLHCs will undermine the very results the FRB is trying to achieve, the FRB itself has acknowledged that certain Insurance-centric SLHCs will require a transition period to build a second accounting system to produce requisite financial reporting and to produce information required to calculate the proposed ratios. The FRB's decision to reverse course now is an error and should be reconsidered.

TIAA-CREF appreciates the flexibility the FRB and our designated Reserve Bank, the Federal Reserve Bank of Boston, have shown as they have assumed supervision for our SLHCs pursuant to Section 312 of DFA. When the FRB began the process of implementing its new supervisory authority over SLHCs, it noted in its April 2011 Notice of Intent that it was considering applying to SLHCs capital and leverage requirements applicable to bank holding companies ("BHCs") "*to the extent reasonable and feasible* taking into consideration the unique characteristics of SLHCs and the requirements of HOLA."[20] In Supervisory Release 11-11, the FRB expressed the view that it would take time for the FRB to understand better SLHCs' business models and operations and that it would take SLHC management time "to make operational changes in response to the Federal Reserve's supervisory expectations."[21] At the same time, the FRB recognized that "SLHCs have traditionally been permitted to engage in a broad range of nonbanking activities that were not contemplated when the general leverage and risk-based capital requirements for BHCs were developed."[22] Similarly, in exempting certain Insurance-centric SLHCs from many of the BHC reporting requirements, the FRB stated that SLHCs, particularly SLHCs that are insurance companies "could not develop reporting systems to comply with the Federal Reserve's existing reporting requirements within a reasonable period of time or without incurring inordinate expense."[23] While the FRB also advised that it would require consolidated

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advertising statement prescribed in § 328.3(b) in all advertisements"). Likewise, insurance regulators' post-crisis restrictions on insurers' security lending activities continue their focus on restricting the risks that insurers are permitted to take. See N.Y. Ins. Dept. Circular Letter No. 16 (2010).

[19] The reporting for compliance with these new capital standards would begin with the March 31, 2013 FR Y-9C filing.

[20] Notice of Intent to Apply Certain Supervisory Guidance to Savings and Loan Holding Companies, 76 F.R. 22,662, 22,665 (Apr. 22, 2011). (emphasis added).

[21] FRB Supervisory Release 11-11 (Jul. 21, 2011)(www.federalreserve.gov/bankinforeg/srletters/sr1111.pdf).

[22] 76 F.R. at 22,665 (Apr. 22, 2011).

[23] 76 F.R. 53,133 (Aug. 25 2011).

reporting in the future, TIAA-CREF reasonably believed that the FRB would afford SLHCs a reasonable period to build the systems necessary to comply with the BHC reporting requirements. In the absence of guidance from the FRB to the contrary, TIAA-CREF has engaged in planning based on our understanding that the FRB's comments recognizing the difficulties Insurance-centric SLHCs would have in building the appropriate systems meant that the FRB would conform its implementation date to the specific effective date for SLHC capital standards set forth in the Collins Amendment to DFA of July 21, 2015.

Simply put, the FRB is now asking Insurance-centric SLHCs that have not been previously subject to consolidated capital requirements to do the impossible. Even if an Insurance-centric SLHC had begun to re-engineer its operations, its compliance systems, its accounting management information systems ("MIS") and its basic capital structure in December 2011,[24] it is unlikely that such work could be completed on time to meet the deadline set forth in the Proposals. Nevertheless, the FRB is now proposing that an insurance group that has heretofore not been subject to U.S. Generally Accepted Accounting Principles ("GAAP") financial reporting or consolidated capital requirements and for which the affiliated savings association constitutes a relatively small percentage of total group assets will somehow be able within a matter of months to comport with bank-centric capital requirements. In addition to never before being subject to consolidated capital requirements, as is the case with all SLHCs, Insurance-centric SLHCs do not engage in a substantial amount of traditional banking activities and therefore have not designed their MIS and other compliance systems to collect and aggregate the types of information necessary to calculate and report regulatory capital ratios on a consolidated basis. Indeed, the financial reporting for BHCs never considered appropriate reporting for the business of insurance and therefore the assumptions underlying its design are inappropriate for supervising an Insurance-centric SLHC.[25]

The Proposals do acknowledge, however, the need for time to transition to new standards, stating:

> [t]his NPR includes transition arrangements that aim to provide banking organizations sufficient time to adjust to proposed new rules and that are generally consistent with the transitional arrangements of the Basel capital framework.[26]

Indeed, the Proposals contain numerous transition periods for banks to comply with changing capital and leverage ratios. Implicit in these transition periods is an understanding that the higher

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[24] Agency Information Collection Activities Regarding Savings and Loan Holding Companies: Announcement of Board Approval Under Delegated Authority and Submission to OMB, 76 F.R. 81,933, at 81,936 (Dec. 29, 2011).

[25] For example, on the FR Y-9C report, most of a life insurer's reserves for policies in force are reported as a summary entry on Schedule HC-I (BHCK B994) that is included in Schedule HC-G as "other" (BHCK B984) which in turn is included in Schedule HC as "other liabilities" (BHDM 2750). No granularity regarding insurance reserves is reported - not even a breakdown between annuity and life insurance reserves.

[26] 77 F.R. at 52,798 (Aug. 30, 2012).

levels of capital will require changes to existing business practices. The recognition that banks need time to adapt to changing requirements makes it all the more unreasonable that the FRB would not afford similar consideration to SLHCs, especially those that are insurance companies.

Congress clearly has articulated its intent to afford SLHCs until 2015 to come into compliance with FRB capital standards. Section 171(b)(4)(D) of DFA (part of the "Collins Amendment") provides that SLHCs should not be subject to consolidated minimum capital requirements until five years after the enactment of DFA or July 21, 2015. The language of Section 171(b)(4)(D) is essentially identical to the language of DFA Section 171(b)(4)(E) which affords U.S. BHCs that are subsidiaries of foreign banking organizations and rely on the Board's Supervision and Regulation Letter SR 01-01 ("SR 01-01 Entities") until July 21, 2015, to comply with the Proposals' capital requirements. The FRB offers no rationale for the disparate treatment between SLHCs and SR 01-01 Entities, nor does there appear to be any justification for doing so. Section 171(b)(4)(D) highlights Congressional recognition that because SLHCs never before have been subject to consolidated capital requirements, they require an extended period of time to bring themselves into compliance with the generally applicable minimum capital requirements contemplated by the Collins Amendment. The analysis is precisely the same for section 171(b)(4)(E), as SR 01-01 Entities are not subject to consolidated capital requirements in the United States, and therefore require a similar extended transition period. Because SLHCs and SR 01-01 Entities are similarly situated, it is unsurprising that the language of sections 171(b)(4)(D) and 171(b)(4)(E) are almost precisely the same. Given Congress's clear intent to provide for similar transition periods for both classes of institutions, it is disconcerting that the FRB arbitrarily has chosen to afford one class the benefit of the plain language of the Collins Amendment, but not the other. Moreover, there is no pressing policy reason to accelerate implementation. Indeed, accelerated implementation will itself create prudential implementation risks.

A second, perhaps more important component of the timing issue are the substantive accounting decisions that must be made as a result of applying an entirely new reporting and associated capital regime (i.e., GAAP) to insurance companies, made all the more difficult by the fact that GAAP was never designed to assess the solvency, safety and soundness of insurance companies. The FRB has acknowledged that some insurance companies that are SLHCs have never utilized GAAP to prepare their financial statements. This includes TIAA, which currently utilizes Statutory Accounting Principles ("SAP") to prepare its financial reports. There are numerous differences between the two accounting systems, the most notable of which is that SAP focuses on insurer solvency whereas GAAP focuses on an organization's earnings. Further, we believe such differences are not relevant to the assessment of capital adequacy due to the conservative nature of SAP.[27]

There are numerous substantive accounting policy decisions associated with insurers implementing this new regime that will require analysis and will affect an insurance company's

[27] Indeed, many of the differences between SAP and GAAP involve adding intangible assets to the balance sheet under GAAP that are not recognized as admitted assets under SAP, particularly goodwill and deferred tax assets. Under the Proposals, both goodwill and the deferred tax assets not recognized under SAP are deducted from common equity in determining Tier 1 capital, thus adjusting GAAP capital back to what it was under SAP.

business and investment decisions. Given the number of important decisions that will have to be made regarding appropriate accounting treatment, it is unreasonable to believe that this transition could be accomplished within the proposed timeframe. This is not simply a matter of devoting funds and resources to meet the proposed deadline because, even with unlimited resources, the operational work associated with such a drastic change could not be prudently accomplished in the time afforded by the Proposals.

IV. Alternative approaches to address capital standards for insurance activities

We believe that the Proposals are significantly flawed when applied to Insurance-centric SLHCs. As discussed above, the business of insurance is fundamentally different than the business of banking. Beginning in 2002, FRB staff recognized the difficulties associated with attempting to "fit" insurers into the BHC model of capital regulation, noting in a 2002 joint report of FRB staff and the NAIC ("2002 Joint Report") that the different capital approaches used by the regulators of insurance companies and banks reflect the "inherent differences between the insurance and banking industries."[28] The different capital approaches "arise from fundamental differences between the two industries, including the types of risk they manage, the tools they use to measure and manage those risks, and the general time horizons associated with exposures from their primary activities."[29]

The appropriate capital standards to apply to insurance activities need to address the true risks of the business of insurance. The existing NAIC RBC regime successfully has addressed these risks on an integrated basis. NAIC RBC is functionally equivalent to the Basel bank capital regime in addressing credit risk and under DFA remains the recognized standard for regulatory actions regarding insurance activities.[30] Accordingly, the Proposals' incorporation of an insurance regulatory capital deduction without considering the assets that support the insurance business is especially inappropriate. The Agencies have the necessary flexibility under their statutory mandates to implement a more appropriate capital regime for insurance activities that does not risk increasing systemic risk and recognizes the fundamental economic differences between insurance and banking. Indeed, such an approach would make the Proposals more consistent with the guidance of the recently released "Principles for the supervision of financial conglomerates" which state "[s]upervisors should apply every effort to avoid creating undue burden through duplication and conflicts between the sectoral standards applied at the conglomerate level."[31] Below we outline two alternatives the Agencies should consider to address these concerns.

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[28] Report of the NAIC and the Federal Reserve System Joint Subgroup on Risk-based Capital and Regulatory Arbitrage. 1 (May 24, 2002).

[29] 2002 Joint Report. 3.

[30] See section 313(k) of DFA continuing the primacy of state regulation of insurance companies.

[31] The Joint Forum: Basel Committee on Banking Supervision, International Organization of Securities Commissions, and International Association of Insurance Supervisors, Principles for the supervision of financial conglomerates, 5-6 (Sept. 2012) (www.bis.org/publ/joint29.pdf).

1. Fundamental Differences Affect the Goals of Capital Standards

Based on the fact that the business of insurance is fundamentally different from the business of banking, the goals of capital standards for insurance companies appropriately vary from those for banks. Insurance products serve very different consumer financial needs than those served by banking products. Insurance products address policyholders' long-term savings and asset protection goals, which are profoundly different than the short-term cash investment objectives of bank depositors. In many cases, the insurance products into which policyholders pay premiums carry with them withdrawal restrictions or are non-cashable. Thus, insurance liabilities exhibit stability and relative illiquidity that fundamentally differentiate them from bank deposits and the insurance regulatory goal of consumer protection leads to a focus on long-term solvency.

Unlike bank deposits, insurance liabilities do not put the FDIC insurance fund at risk. The separate state-based resolution regime for insurance has been maintained under DFA.[32] This state-based regime consists of industry funded guaranty funds and, as a result, prevents the federal government from needing to provide a backstop for policyholder obligations. Because the guaranty funds are funded by the industry itself and the failure of one insurer is borne by the entire industry, guaranty funds create an industry-wide incentive for insurers to monitor the effectiveness of the capital rules to which they are subject. This backstop often goes unnoticed and is little known among consumers because insurers are prohibited from publicly discussing or marketing these protections. Nonetheless, such protections provide a significant mitigant to the systemic risk posed by insurers.

Like the prompt corrective action regulations that use bank capital ratios to trigger supervisory action,[33] NAIC RBC, as enacted through state laws consistent with the NAIC Risk-Based Capital for Insurers Model Act, sets triggers for insurance supervisors to take parallel supervisory actions.[34] The model law creates four action levels under which certain company and regulatory remedial actions are required if capital falls below certain specified NAIC RBC percentages, with progressively more severe actions required at the lower capital levels, up to and including mandatory supervisory seizure of control of an insurer.

The four levels are Company Action Level, Regulatory Action Level, Authorized Control Level and Mandatory Control Level. The action levels are determined by comparing an insurer's total adjusted capital to its authorized control level risk-based capital.

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[32] See section 203(e) of DFA.

[33] Section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o); 12 C.F.R Part 325 subpart B (FDIC regulations); 12 C.FR. Parts 6 and 165 (OCC regulations).

[34] See N.Y. Ins Law §1322 implementing the model law in New York.

a. Company Action Level. An insurer with total adjusted capital of 150 to 200% of authorized control level NAIC RBC triggers the Company Action Level, under which the insurer must submit to the insurance commissioner a comprehensive NAIC RBC plan that identifies the conditions that contributed to the insurer's financial condition and its proposals for corrective action.

b. Regulatory Action Level. When an insurer's total adjusted capital is 100 to 150% of authorized control level NAIC RBC, the commissioner will require submission of an NAIC RBC plan, and also is required to examine the insurer and issue a corrective order specifying required corrective actions.

c. Authorized Control Level. If an insurer's total adjusted capital falls between 70 to 100% of the authorized control level NAIC RBC, the Authorized Control Level is triggered, under which the commissioner is authorized to place the insurer in rehabilitation or liquidation.

d. Mandatory Control Level. Total adjusted capital of less than 70% of authorized control level NAIC RBC triggers the Mandatory Control Level and requires the commissioner to place the insurer in rehabilitation or liquidation.

Two of the primary functions of capital standards for financial institutions are: (1) to set triggers for supervisory action leading up to and including liquidation/resolution and (2) to protect consumers and applicable guaranty funds from loss. For insurance activities in the United States, the relevant and well functioning capital standards for insurance company resolution and policyholder and guaranty fund protection are those established by NAIC RBC.

2. NAIC RBC Right for Insurance Companies

NAIC RBC and related accounting and reserving requirements have been developed over time to address the risks inherent in the business of insurance. They are based on insurance accounting reserves. This is important since such reserves act as a deduction from Tier 1 capital and are not considered within the context of the Proposals unlike loan loss reserves of banks.[35] Under SAP used to calculate NAIC RBC, both assets and liabilities are valued conservatively, resulting in a conservative measure of capital surplus as the model is designed to mitigate any insurance industry systemic risk by promoting individual insurance company solvency standards.[36]

[35] Even when engaged in holding similar assets, insurance companies and banks may utilize different accounting. For example, an insurance company under general U.S. GAAP guidance of ASC 310 will carry mortgage loans held for investment at outstanding principal, adjusted for premium/discount (if applicable) and net of any credit charges or loan loss reserves. In contrast, mortgage banking entities under ASC 948, report loans held for sale at lower of cost or market net of a valuation allowance which is the deficit of market value to cost.

[36] See 2002 Joint Report. 16 ("A main focus of insurance company solvency regulation is the adequacy of technical provisions (reserves reported as liabilities in statutory financial statements). For life and property/casualty insurance companies in the United States, technical provisions for unpaid policy claims are subject to minimum standards (i.e., the reserves must be determined to be adequate to discharge insurance policy obligations. The conservative nature

SAP intentionally avoids application of fair value accounting rules to most life insurance company assets, thereby avoiding unwarranted volatility in regulatory capital, while at the same time recognizing assets whose creditworthiness has been impaired. Such short-term volatility is inappropriate for life insurers who have long-term and inherently stable liability structures. Credit impairments that are other than temporarily impaired ("OTTI") under SAP are recognized and the value of previously impaired assets will remain at the reduced valuation basis.[37]

NAIC RBC provides a comprehensive approach to measure supervisory capital for insurance activities. NAIC RBC for life insurance companies is calculated using a formula that addresses five key risk components:

- C-0 (insurance affiliates and off-balance-sheet items)
- C-1 (asset risk)
- C-2 (insurance risk)
- C-3 (interest rate/market risk)
- C-4 (business risk)

Of these five, asset-related risks are encompassed in the C-0, C-1 and C-3 categories, which measure risks arising from the assets held by the insurance company and its affiliates, including interest rate and market risks associated with the assets held by the insurer and its affiliates.[38] These three components represent in aggregate approximately 75% of the capital charges (pre-covariance adjustments) under the NAIC formula based on 2003 through 2009 aggregate life insurance industry data.[39]

Statistics on the low levels of insurance company failures validate the success of the NAIC RBC approach through and after the recent financial crisis, which is in marked contrast to a higher level of bank failures and the associated high cost to the FDIC insurance fund and the overall affects on the economy during the same period.[40]

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of the margin in technical provisions relative to liability amounts based on best estimate assumptions for life insurers decreases the need for capital to absorb unanticipated losses.").

[37] SSAP 37 and INT 06-07.

[38] These components of the NAIC RBC framework specifically address asset-specific risks and are analogous to the risk-weights assigned under the Basel capital rules for banks.

[39] Exhibit B provides aggregate life insurance industry data for these years and updates the information contained in Exhibit A-2 to the 2002 Joint Report.

[40] See footnote 12. It is important to note that significant Federal intervention was required to prevent the failure of additional banking organizations including several of the largest BHCs during the financial crisis. Only three insurance enterprises participated in the Capital Assistance Program under TARP, in contrast to 705 banking institutions. (source: TARP website)

The NAIC regularly updates and refines its RBC formula to reflect new products and risks faced by insurers. NAIC RBC asset charges were developed from historical actual loss experience over multiple economic cycles. The NAIC (including its various committees) has frequent periodic meetings at which insurance regulators discuss, recommend and adopt changes to the NAIC RBC formula. Leveraging NAIC RBC is a straightforward way for the Agencies to avoid insurers having to manage their businesses under two different capital paradigms, each of which defines its objectives based on industry specific risks, structures and regulatory requirements.

3. Compatibility and Alignment

There exists significant compatibility and alignment between NAIC RBC and the Basel capital frameworks that should be built upon to create appropriate capital standards for insurance-centric enterprises.

a. Comparable comprehensive regimes.

Both NAIC RBC and the Basel capital standards establish comprehensive capital standards for the activities they seek to cover. The Basel standards are nuanced to impose more complex standards on banks that engage in more complex activities and this approach is reflected in the Proposals' application of the advanced approaches requirements to only organizations with over $250 billion in assets or over $10 billion in foreign exposure. Likewise, SAP and NAIC RBC employ reserving methodologies and capital considerations commensurate with the underlying complexity of a company's insurance products and with the goal of policyholder protection. As discussed above, it is inappropriate to establish the scope of coverage of a capital regime without understanding and taking into account the manner in which liabilities are calculated. SAP requires insurance companies to use conservative actuarial calculations to determine the sufficiency of reserves based on stochastic modeling techniques. Deposits and many other liabilities of banks are accounted for at their contractual value, unlike actuarial reserves, which are conservatively modeled for adverse deviation. The Basel bank capital regime focuses heavily on asset/credit risk, whereas NAIC RBC considers both asset and liability risks, and their interactions.

b. Both regimes used as standard for supervisory intervention.

Just as the Basel bank capital standards are used for the bank prompt corrective action triggers, NAIC RBC, through state laws consistent with the NAIC RBC model law, set triggers that grant automatic authority to the state insurance regulator to take specific actions against insurers based on their levels of capital impairment.

c. Misplaced arbitrage concerns.

In the context of an insurance-centric organization, the concern that recognizing differing capital requirements for banking and insurance activities would create regulatory arbitrage opportunities is misplaced. Working in combination, the Basel bank capital standards and NAIC RBC create proper incentives for an organization to book assets in the appropriate legal entity based on their differing liability structures with long-term assets held by the insurance company

and short-term assets held by its depository institution affiliate. Without recognizing NAIC RBC, an Insurance-centric SLHC would be disadvantaged versus its non-SLHC insurance company competitors in purchasing appropriate long-term assets to fund its long-term obligations. Indeed, the FRB would be creating differing capital management incentives for FRB regulated SLHC insurance organizations and non-SLHC insurance companies that will lead to market distortions and economically inefficient regulatory-driven transactions. Through its supervision program, the FRB also has transparency into any SLHC that seeks to engage systematically in regulatory arbitrage and has various supervisory tools that can be utilized to address this risk should it arise.

4. Consequences of Misapplied Standards

a. Capital standards intended to create incentives.

Regulatory capital regimes are intended to create incentives to operate financial institutions in a prudent manner, but different incentives are appropriate for insurance companies and banks. The NAIC RBC regime encourages the matching of cash flows, and in general seeks to have long-term insurance liabilities balanced by holdings of long-term low credit risk assets. The Basel capital regime focuses on minimizing the costs of a rapid liquidation of banking organizations during a period of economic crisis in order to protect depositors and governmental guaranty funds. Thus, the Basel regime as implemented in the United States assumes all liabilities are immediately due and payable, and generally assesses relatively higher capital charges against obligations of private sector non-bank obligors regardless of quality or maturity.[41] The Basel regime, as implemented by the Proposals, encourages the holding of short-term government and agency securities (0% risk-weight), funding of the interbank credit market (20% risk-weight) and discourages the holding of long-term corporate obligations (100% risk-weight) and commercial mortgages (100 – 150% risk-weight). Similarly, the Basel regime recognizes the value of bank and governmental guarantees by lowering the risk-weight of guaranteed assets (a 100% risk-weighted asset becomes a 20% risk-weighted asset), but fails to provide comparable treatment to insurance company guarantees/insurance contracts which are treated as having no value (a 100% risk-weighted asset remains a 100% risk-weighted asset even though guaranteed by an insurance company). Given its focus on banks' inherently short-term financing activities, it is not surprising that the Basel regime encourages unsecured consumer and small business lending, which tend to be floating rate and short-term, yet with historically higher related default rates and credit losses relative to high quality corporate lending/debt.[42] Indeed, the inclusion of loan loss reserves in Tier

[41] Basel II and Basel III give national regulators the ability to recognize lower risk-weights for highly rated corporate obligators including insurance companies, however, the Agencies have chosen not to recognize this higher level of risk granularity. See Basel Committee on Supervision, International Convergence of Capital Measurement and Capital Standards. at paragraph 66 (June 2006) ("Basel II Revised Framework").

[42] See Charge Off and Delinquency Rates on Loans and Leases at Commercial Banks, Board of Governors of the Federal Reserve System. (www.federalreserve.gov/releases/chargeoff/chgallsa.htm) (last updated Sept. 5, 2012).

2 capital to an extent rewards higher risk lending and its related required reserving as long as the organization's reserves in aggregate do not exceed 1.25% of total risk assets.[43]

b. Wrong for insurance, wrong for the economy.

Bank standards would force insurers to change their behavior in ways that hurt their profitability, reduce consumer choice and negatively impact the availability of long-term credit.[44] The Basel standards would encourage investment in illiquid subordinated loans over publicly-traded senior debt securities because there is no recognition of relative risk. Yet under GAAP, only the senior debt would be recorded at fair value with unrealized loses affecting capital. Similarly, to avoid the unwarranted volatility of mark-to-market adjustments, insurers will be encouraged to invest in short-term securities (e.g., T-bills); even though longer-term fixed income investments typically are a better economic match for longer-term liabilities. As a result, the Proposals would tend to increase insurers' exposure to interest rate risk – a mismatch of long-term liabilities with short-term assets.

These incentives to avoid long-term and non-governmental exposures will tend to place insurance guaranty funds and policyholders at risk, without a corresponding supervisory benefit. Policyholders are contracting with an insurer for long-term savings and/or asset protection and are specifically seeking to benefit from an insurer's ability to invest with a longer time horizon and thereby attain higher relative yield, or in the case of asset protection products, lower cost. By discouraging long-term investments, the Proposals ultimately would increase consumers' costs and reduce their returns. Application of the Basel capital regime to the business of insurance is likely to lead to increased macro-prudential risk and potentially significant harm to both consumers and the economy.

Assigning a 100% risk-weight to all corporate bonds may be an appropriate simplification for banks that typically hold relatively few corporate bonds. For insurers, however, the 100% risk-weight significantly overstates the probability of loss on these assets. Moreover, insurers' corporate bond holdings (primarily investment grade) are often among their largest holdings

[43] Measuring this limitation against total risk-weighted assets rather than total loans creates the opportunity for higher risk lending with commensurate higher reserving to inflate Tier 2 capital for banks with a significant proportion of risk assets generated from non-lending activities.

[44] We are already seeing how the conflicting goals of NAIC RCB and the Basel bank capital rules will change our investment process. The Proposals will add not just a new leverage constraint and associated 4% minimum capital charge into our asset allocation modeling process, but also a bank-centric second risk-based capital constraint. This layering of conflicting constraints will change our investment decisions in a manner that reduces our participants' returns, increases risk (particularly increasing the interest rate gap) and reduces long-term investments in the U.S. economy. The regulatory capital charge associated with making an investment is a key factor considered by our investment managers in determining whether to make an investment and under the Proposals this charge is fundamentally changed and consequently their behavior will change.

precisely because of insurers' ability to match the cash flows from these assets to their long-term liabilities.

5. Equivalency and Calibration Solution

We believe that the Agencies should modify the Proposals to recognize that the business of insurance has different economic characteristics and serves different economic purposes than the business of banking and, accordingly, should be measured through capital standards designed to create appropriate incentives and standards for the business of insurance. We strongly support the use of an equivalency and calibration approach for calculating insurance related risk assets of Insurance-centric SLHCs. We believe that the NAIC RBC should be viewed as equivalent to the Basel regime of bank risk-based capital in comprehensively addressing on and off-balance sheet risk and that through calibration of required capital can be incorporated into a consolidated risk-based capital requirement for Insurance-centric SLHCs. As discussed below, we believe that the Collins Amendment and the Agencies' June 28, 2011 final rules implementing the risk-based capital floor ("June 2011 Rulemaking")[45] provide the Agencies with adequate authority to incorporate NAIC RBC into the SLHC capital adequacy framework. Further, such an approach (i.e., to in effect recognize an "insurance book" in addition to the trading and banking books) is entirely consistent with the Basel II and III framework.[46]

a. Holistic approach.

We believe the definition of generally applicable risk-based capital requirements of DFA Section 171(a)(2), which sets a floor for SLHC risk-based capital standards, requires the FRB to determine holistically that the capital, risk-weighted assets and required capital ratios are not less than under the risk-based capital standards applicable to depository institutions. The requirement of DFA Section 171(b)(2) setting the "generally applicable risk-based capital requirements" floor does not require an asset-by-asset testing of risk-weights, but instead speaks to a "numerator" of capital, a "denominator" of risk-weighted assets and a ratio of the two. The Collins Amendment does not require asset-by-asset nor exposure-by-exposure minimum requirements, but instead calls for holistic floors.

b. Precedent for holistic Collins determination.

Under the June 2011 Rulemaking, the Agencies stated that they "anticipate performing a quantitative analysis of any new capital framework developed in the future for purposes of ensuring that future changes to the agencies' capital requirements result in minimum capital requirements that are not "quantitatively lower" than "generally applicable" capital requirements for insured depository institutions in effect as of the date of enactment of the Act." Since the

[45] 76 F.R. 37,620 (June 28, 2011).

[46] See paragraphs 30, 33 and 34 of the Basel II Revised Framework. Under Basel II, assets and liabilities of insurance subsidiaries are deducted and an adjustment to bank capital may be made to reflect the surplus capital in the insurance subsidiary (e.g., the capital in excess of insurance regulatory requirements that is available to be transferred to the parent company) with this residual capital risk-weighted as an equity investment.

Agencies have proposed several reductions in risk-weights for particular assets or off-balance sheet items under the Proposals (e.g., lowering the risk-weight assigned to certain residential mortgages from 50% to 35% and creating incentives for swaps cleared through clearinghouses), the Agencies presumably already have performed or intend to perform such holistic quantitative analysis and could use such an approach to analyze incorporating NAIC RBC into the Basel framework.

c. Equivalency of scope and coverage.

The facts demonstrate that the NAIC RBC is a comprehensive capital regime for insurance activities and in its components of regulatory capital, assigning risk-weights to assets and activities, addressing credit risk, and requiring maintenance of a ratio of capital to asset charges is equivalent in scope and coverage to the Basel requirements.

d. Two alternative approaches to calibration and incorporation of NAIC-RBC into the Proposals.

We believe the Agencies should strongly consider two alternatives to the Proposals' treatment of insurance activities.

1. Deduction and Calibration Alternative. The first is to follow the approach agreed to in Basel II and Basel III and deduct both the capital and assets of insurance subsidiaries. The FRB could then hold these insurance subsidiaries to a prudent level of capital in excess of insurance regulatory minimums with such a standard measured in terms of NAIC RBC. This approach would be consistent with the "not qualitatively less than" requirement of the Collins Amendment since under the Agencies' risk-based capital standards in effect on July 21, 2010, each Agency reserved the right at its discretion to deduct the capital and assets of any subsidiary from the calculation of bank level risk-based capital.[47] Likewise, the "not less than" test of the Collins Amendment would be satisfied by applying this deduction equally to both bank- and holding company-owned insurance company subsidiaries. The resulting standard would remain "on a consolidated basis" since the capital deduction would be part of the numerator calculation and the asset deduction would be part of the denominator calculation for determining a SLHC's capital ratios. Such an approach is identical to the treatment for other assets that are deducted from consolidated capital under the Proposals and still satisfy the "consolidated basis" standard of the

[47] See 12 C.F.R. Part 208 Appendix A, Section II.B.ii. (FRB Regulation H); 12 C.F.R. Part 3, Appendix A, Section 2(c)(7)(i) ("*Deductions from total capital.* The following assets are deducted from total capital: (i) Investments, both equity and debt, in unconsolidated banking and finance subsidiaries that are deemed to be capital of the subsidiary; and [t]he OCC may require deduction of investments in other subsidiaries and associated companies, on a case-by-case basis"); 12 C.F.R Part 325, Appendix A, Section II.B.3. (FDIC regulations) ("FDIC may also consider deducting investments in other subsidiaries, either on a case-by-case basis or, as with securities subsidiaries, based on the general characteristics or functional nature of the subsidiaries.").

Collins Amendment.[48] On a preliminary basis, we believe setting an NAIC RBC ratio of 300% as equivalent to the well-capitalized ratios required for banks is appropriate.

This approach solves: (1) the Agencies current situation where the Proposals' treatment of insurance is inconsistent with Basel III as is noted in a recent report of peer international supervisors;[49] (2) the problems for insurers of needing to manage their business to conflicting risk-based capital regimes and (3) the potential harm to the economy of reduced long-term private sector financing.

2. Conversion and Calibration Alternative. The second alternative has been proposed by the ACLI in its comment letter dated October 12, 2012. Under this approach as outlined in Appendix AA to the ACLI's letter, NAIC RBC is used to calculate risk-assets to be included in the SLHC's risk-based capital calculations. This approach incorporates NAIC RBC into the Basel-based rules in a manner that avoids the misalignment of the incentives for managing insurance activities through a quantitative calibration of insurance capital requirements with and into the Basel requirements. Thus, it maintains the numerators of Tier I common equity, Tier 1 capital and total capital, and through a calibrated conversion process calculates risk-weighted assets for the denominator and the capital ratio calculations.

e. Consolidated coverage.

Under these approaches only activities conducted under an insurance company would be subject to NAIC RBC and any non-insurance subsidiary of a SLHC not also an insurance company would be subject to Basel capital standards. Likewise, the activities of the thrift subsidiary would remain subject to Basel capital standards. In combination, all activities would be subject to consolidated capital requirements. This eliminates the regulatory gap that led to AIG Financial Products not being subject to regulatory capital requirements.[50] A non-insurance subsidiary of a

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[48] See §_____.22 Regulatory capital adjustments and deductions generally deducting items from Tier 1 common equity and subsection (f) treatment of assets that are deducted – "A [BANK] need not include in risk-weighted assets any asset that is deducted from regulatory capital under this section." 77 F.R. at 52,863 (Aug. 30, 2012).

[49] See Basel Committee on Banking Supervision, Basel III regulatory consistency assessment (Level 2) Preliminary report: United States of America. 20 (Oct. 2012) ("Nonetheless, the assessment team has identified a difference in the treatment of insurance subsidiaries that may be potentially material and has listed it for further follow-up analysis").

[50] Indeed, the Financial Crisis Inquiry Report concluded "because of the deregulation of OTC derivatives, state insurance supervisors were barred from regulating AIG's sale of credit default swaps even though they were similar in effect to insurance contracts. If they had been regulated as insurance contract, AIG would have been required to maintain adequate capital reserves, would not have been able to enter into contracts requiring the posting of collateral, and would have not been able to provide default protection to speculators; thus AIG would have been prevented from acting in such a risky manner." The Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report, 352 (Jan. 2011) (http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf).

non-insurance company SLHC would be subject to the Basel risk-weighting and consolidated capital requirements under these approaches.

f. Leverage ratio acts as a floor.

Under these proposed approaches, the consolidated leverage ratio requirement of holding 4% Tier 1 capital to average total assets would continue to set a universal capital floor for all SLHC activities, including those conducted through insurance companies.

g. Consistent with DFA Congressional intent.

We believe Congress clearly demonstrated its intent to allow Insurance-centric SLHCs continue to own thrifts throughout the DFA legislative process and in the text of various provisions within DFA. Congress went so far as to instruct "the Federal Reserve [to] take into account the regulatory accounting practices and procedures applicable to, and capital structure of, holding companies that are insurance companies (including mutuals and fraternals), or have subsidiaries that are insurance companies" in determining SLHC capital standards.[51] Congress specifically did not make SLHCs BHCs. DFA left in place the provisions of the Gramm-Leach-Bliley Act, which grandfathered nonbank activities of certain SLHCs, maintained the Qualified Thrift Lender test and maintained the thrift charter. Indeed, as demonstrated by the Volcker Rule insurance exemption, Congress expected insurance companies to own thrifts.[52] In DFA, Congress clearly demonstrated its intent that insurance-centric organizations would continue to own thrifts and offer their customers banking products and services. Unfortunately, FRB oversight as implemented through the current Proposals will make continued ownership of thrifts by insurance organizations economically prohibitive and thereby have done through regulation what Congress, not only did not intend to do by statute,[53] but what it specifically directed the FRB to avoid doing.

h. Limited potential for BHCs to engage in regulatory arbitrage.

We recognize the FRB's historic concerns regarding regulatory arbitrage. The equivalency and calibration approaches do not provide free rein to BHCs to park assets with insurance affiliates to lower their consolidated capital requirements, because they could be tailored to apply to

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[51] Senate Report 111-176 at footnote 161 (Apr. 30, 2010) – discussion of Section 616 amending HOLA to clarify the FRB's authority to issue capital regulations for SLHCs where the Committee specifically notes:

> It is the intent of the Committee that in issuing regulations relating to capital requirements of bank holding companies and savings and loan holding companies under this section, the Federal Reserve should take into account the regulatory accounting practices and procedures applicable to, and **capital structure of, holding companies that are insurance companies (including mutuals and fraternals)**, or have subsidiaries that are insurance companies." [emphasis added].

[52] Section 619(d)(1)(F) of the DFA.

[53] "Dodd-Frank amps insurers for banking exit," SNL Financial (Jul. 11, 2012).

organizations primarily engaged in the business of insurance and then only for activities of regulated insurance companies. In addition, these approaches could include a provision providing the Agencies with discretion to apply the general bank risk-weights to insurance company assets on a case-by-case basis in order to counter identified cases of regulatory arbitrage. We do not believe any BHC or FHC would have an incentive to become primarily engaged in the insurance business in order to take advantage of the differing capital treatment of individual assets under NAIC RBC and the Basel capital standards. Indeed, regulatory arbitrage between these two standards cannot be eliminated for the financial system as a whole unless all regulated and unregulated financial institutions are subjected to a single integrated capital standard. In this regard, we are concerned that insurance companies not subject to FRB oversight will set the market price for insurance products and that the additional capital and other costs imposed by FRB oversight will make insurance products offered by SLHC affiliated insurance companies non-competitive.

6. Insurance Capital Deduction Inappropriate

Irrespective of the equivalency and calibration approaches suggested above, the Proposals' treatment of insurance underwriting subsidiaries, under which they are first consolidated for purposes of determining SLHC risk-weighted assets and then a deduction from Tier 1 and Tier 2 capital (the "Insurance Capital Deduction") is made for the insurance subsidiary's minimum required capital amount (the "Consolidate and Deduct Approach"), is inappropriate.

a. The 2007 Advanced Approaches rulemaking.

FRB staff has pointed to the 2007 Advanced Approaches rulemaking process as demonstrating that the Consolidate and Deduct Approach already has been fully considered and that the FRB is just applying its existing policy to SLHCs.[54] We are troubled by this position given the context and different constituents affected by the rulemaking and by the implication that the principles of stare decicus and collateral estoppel apply to this "policy" decision. Both on process and policy grounds the record underlying the 2007 rulemaking does not support the Insurance Capital Deduction. Our review of the comments the Agencies received on the Advanced Approaches Releases revealed only five comment letters addressing the Consolidate and Deduct Approach with three opposing consolidation. The only letter supporting consolidation was submitted by Citigroup after its spin off of Travelers Insurance, and Citigroup only supported a possible capital deduction for risks such as mortality or morbidity with proxies derived from the NAIC RBC requirements.[55] None of the comment letters supported deducting insurance capital supporting affiliate (C-0), asset (C-1) or interest rate/market risk (C-3).

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[54] The advanced approaches rulemaking process included the 2003 advanced notice of proposed rulemaking [68 F.R. 45,900 (Aug. 4, 2003)], the notice of proposed rulemaking [71 F.R. 55,830 (Sept. 25, 2006)], and the final rule [72 F.R. 69,288 (Dec. 7, 2007)] (collectively, the "Advanced Approaches Releases").

[55] Citigroup Letter (Nov. 3, 2003) (http://www.federalreserve.gov/SECRS/2003/November/20031118/R-1154/R-1154_62_1.pdf); HSBC North America Holdings Letter (Mar. 26, 2007) (http://www.fdic.gov/regulations/laws/federal/2006/06c50ac73.pdf); The Risk Management Association Letter (Mar. 26, 2007) (http://www.fdic.gov/regulations/laws/federal/2006/06c75ac73.pdf); Bank of America Letter (March 26,

It is not surprising that no insurance companies participated in this highly technical and extended rulemaking process, because the Advanced Approaches Releases, by their terms, would not apply to an insurance organization unless it both had $250 billion in non-insurance assets and was already a BHC. Indeed, the FRB specifically stated that the Advanced Approaches framework was inappropriate to apply to insurance activities.[56] The FRB should re-examine this issue anew in light of the significant effect the Consolidate and Deduct Approach will have on Insurance-centric SLHCs.

In the preamble to the 2007 final rule implementing the Advanced Approaches, the FRB stated, in response to the banking industry comments discussed above objecting to the required deduction of capital held by insurance underwriting subsidiaries, that it:

> [does] not agree that the proposed approach results in a double-count of capital requirements. Rather, the capital requirements imposed by a functional regulator or other supervisory authority at the subsidiary level reflect the capital needs at a particular subsidiary. The consolidated measure of minimum capital requirements should reflect the consolidated organization.[57]

The FRB's policy rationale for the Insurance Capital Deduction differs in the various rulemaking releases associated with the extended Advanced Approaches rulemaking.[58] Starting with the 2002 Joint Report, FRB staff has expressed a view that "it may be appropriate to deduct the insurance company's capital, or at least a portion of capital, not freely available to the holding company before calculating the consolidated capital ratio."[59] Yet even in 2002, over 76% of life insurance capital was understood to be held against risks comparable to those covered under the Basel framework.[60] The concept that capital is somehow maintained at the holding company level

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2007) (http://www.fdic.gov/regulations/laws/federal/2006/06c47ac73.pdf); Wachovia Corporation Letter (Mar. 26, 2007) (http://www.fdic.gov/regulations/laws/federal/2006/06c62ac73sup.pdf).

[56] "The final rule continues to exclude assets held in an insurance underwriting subsidiary of a BHC from the asset threshold because the advanced approaches were not designed to address insurance underwriting exposures." 72 F.R. at 69,298 (Dec. 7, 2007).

[57] 72 F.R. at 69,325 (Dec. 7, 2007).

[58] See 68 F.R. 45,907-8 (Aug. 4, 2003)(no mention of regulatory arbitrage, but "[a] deduction would be required for capital that is not readily available at the holding company level for general use throughout the organization."); 71 F.R. at 55,857-8 (Sept. 25, 2006)(again no mention of regulatory arbitrage, but belief that "full deconsolidation and deduction approach does not fully capture the risk in insurance underwriting subsidiaries at the consolidated BHC level..."); 72 F.R. 69,325 (Dec. 7, 2007)(first raising a regulatory arbitrage concern – "it eliminates incentives to book individual exposures at a subsidiary that is deducted from the consolidated entity for capital purposes where a different, potentially more favorable requirement is applied at the subsidiary.")

[59] 2002 Joint report. 11.

[60] Id. Exhibit A-2.

is extremely odd in light of the reality of financial holding company ("FHC"), BHC and SLHC structures, where the vast preponderance of parent company assets are in the form of investments in their subsidiaries. Only in the case of insurance companies is the FRB imposing a penalty for minimum capital requirements of a subsidiary.

Unsurprisingly, the Advanced Approaches Releases assume a typical BHC structure in which insurance companies and banks are sister subsidiaries of a common holding company parent. While such a structure is predominant for BHCs, the structure of Insurance-centric SLHCs is more diverse with most having their thrifts owned under an insurance company that is itself registered as a SLHC and many insurance companies that are SLHCs have insurance company subsidiaries for business or regulatory reasons. This situation is not contemplated in either the Advanced Approaches Releases or the Proposals.

b. Why the Insurance Capital Deduction is inappropriate and discriminatory.

The FRB's position that NAIC RBC does not address credit risk is factually incorrect. As discussed above, for life insurance companies 75% of their NAIC RBC capital requirement reflects risks comparable to those for which capital requirements are applied under the Proposals. Why the FRB has chosen to single out the insurance industry for this draconian deduction appears to be based on regulatory history, rather than considered regulatory policy. All holding company subsidiaries that have minimum regulatory capital requirements are limited in how much financial support they may provide to their parent holding companies. All other types of regulated holding company subsidiaries are consolidated under the Proposals with no required capital deduction. Even though broker-dealers, future commission merchants and most importantly bank subsidiaries are restricted by their respective capital regimes from being able to provide financial support to their parent and/or affiliates when they would fall below regulatory minimums, ONLY in the case of insurance companies has the FRB required a deduction from holding company capital.

If the approach of the Insurance Capital Deduction were to be followed for all BHC regulated subsidiaries, including banks, it would be quite difficult for any existing BHC to satisfy the Proposals' minimum capital standards. Nevertheless, the FRB proposes to apply such a discriminatory deduction to Insurance-centric SLHCs with equally inappropriate results.

Further, the deduction is inappropriate based on the assumption in the FRB's 2007 Rulemaking of a typical BHC organizational structure with a public holding company parent. This is not the case for many Insurance-centric SLHCs, where insurance companies themselves or special purpose non-public entities are often the top level SLHCs. If this deduction were imposed at the level of the TIAA Board of Overseers (the special purpose non-profit entity that owns TIAA),[61] then the deduction of TIAA's required control amount would reduce consolidated capital by nearly 20%. Yet nearly 100% of consolidated assets and all associated financial activities, including all banking activities, are recorded at the level of TIAA and its subsidiaries. How would

[61] This approach would be contrary to current and historic supervisory practice of focusing supervision on TIAA.

such a deduction protect TIAA's thrift subsidiary? What purpose would the deduction serve? Alternatively, would the deduction be applied at the TIAA level and only TIAA's insurance subsidiary TIAA-CREF Life Insurance Company's capital be deducted from TIAA's total capital? How do the Proposals contemplate the treatment of capital of insurance companies that own insurance companies?

Notwithstanding the forgoing, if the FRB still deems it necessary for a SLHC to deduct capital held by an insurance underwriting subsidiary, such a deduction should be limited to capital held against insurance underwriting risk (e.g., C-2), which like may other risks faced by financial institutions is not specifically addressed by the Basel framework.[62]

V. Exclude insurer separate accounts from the leverage ratio and ensure they receive the same treatment as similar bank affiliated investment vehicles

We disagree with the Proposals' inclusion of insurance company separate account assets in the denominator of the proposed Tier 1 leverage ratio. This inclusion is contrary to the FSOC's determination that separate accounts are "not available to claims by general creditors of a nonbank financial company" and, therefore, should be excluded from the calculation of the leverage ratio used in the DFA Section 113 determination process.[63] The Agencies' implicit rationale for the inclusion of separate account assets appears to be based on GAAP's treatment of separate account assets as balance sheet assets of an insurance company. The Agencies, however, have selectively chosen to overlook the accounting treatment of other assets when in their view the underlying economic value/risk varies from the treatment afforded under GAAP. Specifically, in the areas of the value of goodwill, mortgage servicing rights and deferred tax assets, the Agencies have adjusted GAAP measurements for purposes of the calculation of various regulatory capital considerations as well as the leverage ratio, to reflect the underlying economics of these assets in the context of prudential oversight and supervision. Yet, to the best we have been able to determine, the rationale for inclusion of separate account assets in the leverage ratio calculation is that "GAAP treats them as balance sheet assets."[64]

Importantly, this position misconstrues the position of the Financial Accounting Standards Board ("FASB") regarding the treatment of separate account assets for financial reporting

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[62] We would note that, under the general Basel framework, BHCs do not hold capital against regulatory compliance risk, reputational risk, interest rate risk and operational risk (except for Advanced Approaches institutions), yet under the Proposals only insurance enterprises would be subject to a capital deduction for a risk not specifically addressed by the framework.

[63] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 F.R. 21,637, 21,661 (Apr. 11, 2012).

[64] See Ask the Fed: Basel III for banking organizations with assets of at least $50 billion (Jul. 17, 2012) at minute 101 of the archived audio recording.

purposes.[65] Under GAAP treatment of separate accounts, separate account assets representing contract holder funds are reported on an insurance company's financial statements as a summary total with an equivalent summary total reported for related liabilities, if the following requirements are satisfied:[66]

a. the separate account is recognized legally, that is, the separate account is established, approved, and regulated under special rules such as state insurance laws, federal securities laws, or similar foreign laws;

b. the separate account assets supporting the contract liabilities are insulated legally from the general account liabilities of the insurance entity, that is, the contract holder is not subject to insurer default risk to the extent of the assets held in the separate account;

c. the insurer must, as a result of contractual, statutory, or regulatory requirements, invest the contract holder's funds within the separate account as directed by the contract holder in designated investment alternatives or in accordance with specific investment objectives or policies; and

d. all investment performance, net of contract fees and assessments, must as a result of contractual, statutory, or regulatory requirements be passed through to the individual contract holder. Contracts may specify conditions under which there may be a minimum guarantee, but not a ceiling, as a ceiling would prohibit all investment performance from being passed through to the contract holder.

This presentment reflects a recognition of the legal, but not economic, ownership of separate account assets by an insurance company. Most clearly this is seen in the requirement that only fees and assessments related to the separate account and not income and other expenses are reported on the insurance company's statement of operations – a treatment mirroring that of affiliated mutual funds.[67] Indeed, to the extent that an insurance company has an economic interest in assets maintained in a separate account or has any liability related to the separate account in excess of the fair value of the separate account's assets, GAAP requires such assets and liabilities to be reported as general account assets and liabilities.[68] The underlying economic reality of separate account assets and related liabilities has not been clearly considered in the Agencies' proposed approach to rely on total assets including separate account assets for calculation of the leverage ratio. Any contingent obligations regarding a separate account would be recognized by the insurer in accordance with the applicable general account reporting

[65] ASC 944-80 (Financial Services – Insurance, Separate Accounts).

[66] ASC 944-80-25-2.

[67] ASC 944-80-25-3(c). Under ASC 944-80-25-4(c), only revenue and expense of non-qualifying separate accounts are reported on the insurance company's statement of operations.

[68] ASC 944-80-25-3(b) and ASC 944-80-25-4.

requirements, and the appropriate means to address concerns regarding contingent obligations is through the risk-based capital framework, not the leverage ratio.

The Proposals' treatment of separate accounts is a significant issue for life insurance companies and the consumers who rely on them for lifetime income and retirement savings products. Variable annuity contracts funded by insurance company separate accounts are a significant investment vehicle for individuals to use for their retirement savings. As of 2010, $1.3 trillion was invested in 32.4 million variable annuity policies.[69] In the retirement space, variable annuity products compete with mutual funds and collective investment funds as funding alternatives for defined contribution retirement plans.[70] Nevertheless, annuities, unlike mutual funds or collective investment funds, offer payout options that are designed to provide lifetime income.[71]

The Agencies' proposed inclusion of separate accounts in the calculation of the leverage ratio stands in marked contrast to the agencies' treatment of bank-affiliated mutual funds and bank-maintained common and collective investment funds. We recognize that mutual funds and common and collective investment funds are not included as balance sheet assets under GAAP. Even so, the economics, risk and regulatory relationship of these vehicles to banks is nearly identical to the relationship of separate accounts to an insurance company.[72] Indeed, most separate accounts supporting variable annuities are registered with the SEC as unit investment trusts under the Investment Company Act of 1940 and invest in mutual fund shares. For example, a bank may act as a trustee of a retirement plan (e.g., have technical legal ownership of the plan's assets as trustee) and the plan can invest in mutual funds advised by the bank's affiliates and the bank will have no capital charge under the leverage ratio for the plan's mutual fund holdings. In contrast, under the Proposals, when an insurance company issues a variable annuity contract to fund the same retirement plan and for which insurance company affiliate-advised mutual funds are the underlying investments held in a separate account, the insurance company would need to hold at least 4% Tier 1 capital against these mutual fund shares held in the separate account.

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[69] ACLI Product Line Report: Annuity Insurance (Jan. 2012).

[70] Just under 70% of separate account assets fund qualified retirement plans, including IRAs. Id.

[71] The importance of providing consumers with annuities as retirement plan options to address longevity risk has recently been highlighted by both the U.S. Department of Labor and the President's Council of Economic Advisers. See Executive Office of the President, Council of Economic Advisers, Supporting Retirement for American Families, (Feb. 2, 2012) (www.whitehouse.gov/sites/default/files/cea_retirement_report_01312012_final.pdf) and Department of Labor Press Release, "U.S. Treasury, Labor Departments Act to Enhance Retirement Security for an America Built to Last." (Feb. 2, 2012) (www.treasury.gov/press-center/press-releases/Pages/tg1407.aspx).

[72] See New York Law Insurance Law § 4240 ("If and to the extent so provided in the applicable agreements, the assets in a separate account shall not be chargeable with liabilities arising out of any other business of the insurer"). Which is in effect parallel to the treatment of fiduciary assets of a bank under 12 U.S.C. § 1464(n)(2) ("A Federal savings association exercising any or all of the powers enumerated in this section shall segregate all assets held in any fiduciary capacity from the general assets of the association").

Under the Proposals, the Agencies are in effect imposing a capital "tax" on insurance company variable products, while exempting comparable bank products from such a requirement. We believe this position is not supported by any public policy rationale, favors bank products over competing insurance products, and will negatively effect consumers' ability to obtain access to appropriately priced lifetime income and retirement savings products. We believe the inclusion of separate account assets in the leverage ratio has significant anti-competitive implications and a detrimental consumer impact. Accordingly, the Proposals should be modified to exclude separate account assets from the leverage ratio calculation.

VI. Affects of recording AOCI for unrealized capital gains and losses

We have concerns with provisions in the Proposals that would require insurers to record unrealized gains and losses on financial instruments within regulatory capital ["accumulated other comprehensive income ("AOCI")], thus recording unrealized gains and losses of certain debt securities in common equity Tier 1 capital. The Agencies recognize that, "including unrealized gains and losses related to certain debt securities whose valuations primarily change as a result of fluctuations in a benchmark interest rate could introduce substantial volatility in a banking organization's regulatory capital ratios."[73] We believe this statement is especially true for insurers, whose business requires investments in long-dated fixed income securities that are susceptible to such volatility.

The business of insurance largely involves investing assets on behalf of policyholders in a way that will ensure these assets are available for policyholders and/or their families at a future date. As a result, insurers invest heavily in long-term fixed income assets that can be greatly affected by the interest rate fluctuations referenced by the Agencies. Insurers tend to have a larger portion of their investments in longer-term interest rate-sensitive securities when compared to banks. For example, insurers held $2.5 trillion of bonds in their general accounts in 2010, and 62% of these holdings were in bonds with maturities of 10 years or more.[74]

Recording unrealized gains and losses certainly would increase volatility resulting from either interest rate fluctuations or other factors that affect the short-term valuations of investments (e.g., market illiquidity) and would disproportionately affect insurers' regulatory capital calculations compared to traditional banking organizations

To avoid the negative affects of non-credit fluctuations on their capital ratios, many insurers may decrease investments in longer-duration securities, which, considering the significant investment activity of insurers in these securities, not only would decrease the availability of long-

[73] 77 F.R. at 52,811 (Aug. 30, 2012).

[74] ACLI, 2011 Life Insurers Fact Book, 8 (2011) (www.acli.com/Tools/Industry%20Facts/Life%20Insurers%20Fact%20Book/Documents/2011%20Fact%20Book.pdf).

term credit in the economy, but also would effect insurers' ability to best match asset and liability duration.

We strongly support the exclusion of unrealized gains and losses related to long-term debt securities, including long-term debt securities whose valuations primarily change because of fluctuations in interest rates, within the calculation of regulatory capital. Such securities include, but are not limited to, long-term Treasuries, securities issued or guaranteed by Fannie Mae and Freddie Mac, long-term obligations of U.S. states and municipalities, and other forms of long-term debt securities.

In the absence of such exclusion, insurers would be forced to diminish their investments in long-term debt securities and increase the amount of short-term debt securities held in their general accounts. Because insurers rely on long-dated assets to match their long-term liabilities, such a shift would counteract the safety and soundness principles utilized by insurers by making it more difficult for them to engage in effective asset-liability management.

An exclusion of unrealized gains and losses from long-term debt securities is appropriate for measuring the regulatory capital requirements of insurers because of the nature of their business model compared to traditional banking organizations. Furthermore, it is integral to ensuring that Americans who rely on insurance products for their lifelong financial security are not suffering disproportionate negative effects from the imposition of such a proposal.

VII. Capital treatment of owned securitizations

We have concerns with the proposed securitization framework outlined in the Proposals, requiring banking organizations to satisfy specific due diligence requirements for securitization exposures. As part of this due diligence, a banking organization must conduct a detailed analysis of all owned securitization vehicles no less frequently than quarterly and maintain an extremely granular level of data for all such investments. As part of this analysis, banking organizations "would be required to demonstrate to the satisfaction of their primary federal supervisor a comprehensive understanding of the features of a securitization exposure that would materially affect the performance of the exposure." The banking organization's analysis would be required to correspond with the complexity of the exposure and the materiality of the exposure in relation to capital.

Demonstrating such a comprehensive understanding would require the banking organization to conduct and document an analysis of the risk characteristics of the exposure prior to acquisition and periodically thereafter. As part of this analysis, the banking organization would need to consider various factors including any structural features of the securitization that could materially influence the performance of the exposure, relevant information regarding the performance of the underlying credit exposure, and relevant market data on the securitization. If a banking organization were unable to demonstrate a comprehensive understanding of an exposure, it would be required to assign a risk weight of 1,250% to the exposure.

This new requirement likely would call for most banking organizations to enhance their recordkeeping and tracking processes for securitization activity. Traditional banking organizations that own and originate such securitized vehicles would have in place the systems and compliance infrastructure necessary to manage proprietary loan data, enabling such organizations to better prepare for the proposed due diligence requirements.

By contrast, implementing these enhancements may prove to be an excessive burden for insurers who invest in, but do not originate the loans included in these securitized vehicles, and therefore do not have the same level of data as the loan originator. This dichotomy in data collection capability places insurers at a significant disadvantage relative to traditional banking organizations, and will make it substantially more difficult for insurers to comply with the proposed due diligence requirements for securitizations. Further, if insurers were to determine that the proposed requirements were too burdensome, too costly to implement, or too difficult to maintain, insurers would likely diminish their investments in such securitized vehicles. Removing insurance enterprises as an investor in these vehicles has the potential to diminish the liquidity currently available in the private securitization market.

It is also worth noting that insurers primarily invest in the high quality, upper tranches of the securitization exposures. In fact, two recent NAIC studies looking at recent changes made to the procedure for assigning NAIC designations to non-agency residential mortgage-backed securities ("RMBS") and commercial mortgage-backed securities ("CMBS") demonstrated that 95% of insurer investments in CMBS and 80% of insurer investments in RMBS received either the highest or second highest NAIC-assigned ratings.[75] These studies reflect continued improvements in insurers' methodologies for assessing the credit quality of securitization exposures based on experience of the recent crisis as well as insurers' overall investment history in securitizations as a long-term investment, and demonstrates that insurers both understand the credit risk inherent in securitization exposures and are committed to holding adequate capital for these exposures.

The results of these NAIC studies indicate that the insurance industry already has adequate measures in place that have resulted in improvements in transparency and regulatory oversight of the securitized vehicles, as well as accurate valuation processes. We believe that the current process and modeling results show the strong principles maintained by the insurance industry with regard to ensuring adequate levels of capital and that insurance holdings are appropriately sensitized to the credit risks inherent in securitization activities.

Finally, as the FRB moves forward with the rulemaking with respect to securitization exposures of insurers, we strongly recommend reviewing the SSAP 43R standard, which requires investors conduct a prudent discounted cash flow ("DCF") analysis of their investment and record valuation impairments based on proprietary valuation results compared to the externally derived NAIC valuation.

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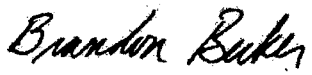
[75] See NAIC, Modeling of U.S. Insurance Industry's Holdings in Commercial Mortgage-Backed Securities, (www.naic.org/capital_markets_archive/120626.htm); NAIC, Modeling of U.S. Insurance Industry's Holdings in Residential Mortgage-Backed Securities, *available at* http://www.naic.org/ capital_markets_archive/120601.htm.

VIII. Conclusion

As the Agencies and particularly the FRB implement their responsibilities under DFA, we hope that they will keep in mind the ancient maxim - *Primum non nocere* – "**First, do no harm.**" We believe that, if the Agencies fail to address our concerns regarding the impact of the Proposals on insurance companies, the likely outcome will be the continued exiting of banking by these firms, which would result in an increase in the concentration of banking activities in a few systemically significant firms as well as a reduction in competition and consumer choice. Capital regulation for insurance activities in the United States is important to get right because it affects Americans' ability to mitigate longevity, mortality and catastrophe risks as well as the availability of long-term financing for the economy. Insurance capital regulation is not a problem looking for a solution – NAIC RBC works. Just as the Basel framework addresses trading and banking activities separately, it also addresses how insurance activities should be treated by respecting the insurance sectoral standards at the "conglomerate level" through a parallel capital and asset deduction. As drafted, the Proposals are inconsistent with Basel III and would harm consumers, insurers and the economy, while providing no discernable supervisory benefit. We have outlined above two alternative approaches that would allow the Agencies to satisfy their mandate under the Collins Amendment, while simultaneously avoiding disruption to consumers, insurers and the economy.

Again, we appreciate the opportunity to participate in this critical rulemaking process and are more than willing to discuss our views further to assist the Agencies in this important endeavor.

Very truly yours,



Brandon Becker
Executive Vice President and
Chief Legal Officer

cc: Mr. Michael McRaith
Director, Federal Insurance Office
U.S. Department of the Treasury

Exhibit A - Corporate and Foreign Bonds

Billions of dollars; amounts outstanding end of period, not seasonally adjusted

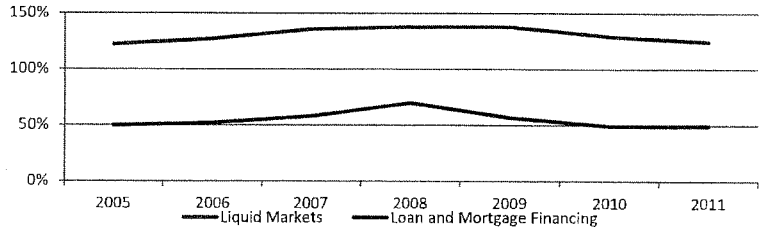
	2006	2007	2008	2009	2010	2011	Q2 - 2012	Relative Holdings Q2 - 2012
Household sector	$1,653.5	$2,118.4	$2,052.8	$2,213.1	$2,185.8	$2,118.1	$1,948.9	16.30%
State and local governments	135.0	149.1	147.9	154.7	157.0	150.6	147.0	1.23%
Federal government	0.0	0.0	0.0	0.6	0.9	0.8	0.8	0.01%
Rest of the world (2)	2,320.5	2,719.1	2,354.0	2,465.3	2,523.3	2,500.5	2,444.7	20.45%
U.S.-chartered depository institutions	563.4	714.6	650.5	667.1	548.9	551.8	528.9	[redacted]
Foreign banking offices in U.S.	292.5	369.5	401.6	244.9	233.9	234.5	216.6	1.81%
Banks in U.S.-affiliated areas	0.4	0.5	0.5	2.0	0.6	4.2	4.1	0.03%
Credit unions	30.6	34.6	25.7	18.6	3.7	4.1	4.8	0.04%
Property-casualty insurance companies	277.0	282.9	267.5	298.3	322.6	361.0	359.5	[redacted]
Life insurance companies	1,819.5	1,862.6	1,817.0	1,927.2	2,030.2	2,123.6	2,124.8	[redacted]
Private pension funds	317.6	357.4	400.1	442.9	440.1	440.9	437.4	3.66%
State and local govt. retirement funds	283.4	297.0	312.9	308.6	312.4	320.9	324.5	2.71%
Federal government retirement funds	4.8	6.3	5.8	5.8	5.9	7.4	8.0	0.07%
Money market mutual funds	368.3	376.8	228.0	169.9	154.2	129.6	116.5	0.97%
Mutual funds	767.0	889.9	959.9	1,126.8	1,275.4	1,465.8	1,617.8	13.53%
Closed-end funds	75.1	74.0	49.2	55.4	59.5	57.6	60.5	0.51%
Exchange-traded funds	7.6	13.8	27.7	55.4	74.1	107.7	135.7	1.13%
Government-sponsored enterprises	481.7	464.4	386.6	310.8	293.9	260.5	227.1	1.90%
Finance companies	184.8	189.4	192.4	198.6	84.3	85.1	87.2	0.73%
REITs	64.6	34.4	11.7	15.5	20.8	22.1	27.6	0.23%
Brokers and dealers	355.5	382.8	123.8	154.4	189.5	103.7	135.5	1.13%
Holding companies	16.7	35.9	35.8	31.1	38.3	18.3	94.3	0.79%
Funding corporations	60.4	170.0	667.3	710.2	760.1	792.4	904.3	7.56%
Total assets	$10,080.0	$11,543.4	$11,118.5	$11,577.0	$11,715.3	$11,861.1	$11,956.6	100.00%

FEDERAL RESERVE statistical release - Flow of Funds Accounts of the United States,
Flows and Outstandings Second Quarter 2012, 100 (Sept. 20, 2012) - L.212 Corporate and Foreign Bonds.

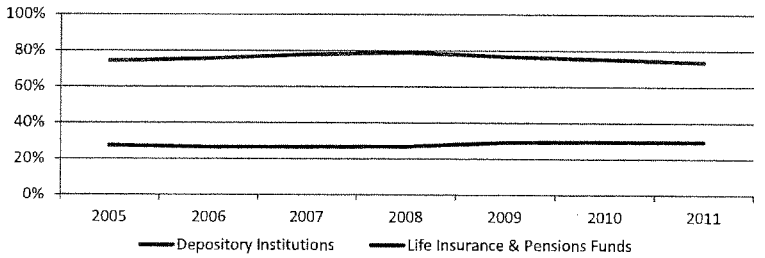
Exhibit A - Composition of U.S. Credit

Composition of U.S. Credit
Financing and Holdings

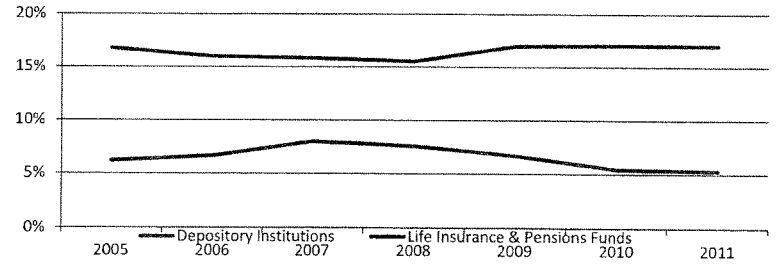
Total U.S. Business Financing: Percent of GDP
Liquid Securities versus Loan and Mortgage Financing



Total U.S. Credit Market Instrument Holdings: Percent of GDP
Depository Institutions versus Life Insurers and Private Pension Funds



Total U.S. Corporate and Foreign Bond Holdings: Percent of GDP
Depository Institutions versus Life Insurers and Private Pension Funds



Note: Liquid Markets is composed of commercial paper, municipal securities, and corporate bonds. Loan and Mortgage Financing is composed of depository institutions loans, other loans and advances, net inter bank lending, and mortgages, less reserves and vault cash at the Federal Reserve Banks.
Source: Federal Reserve Bank System Flow of Funds

Exhibit B - compositon of NAIC RBC by risk element - 2003-2009

	2009	2008	2007	2006	2005	2004	2003
C-0 - Asset Risk - Affilates	16.25%	15.70%	17.26%	16.26%	16.56%	17.67%	18.09%
C-1Cs - Asset Risk - Common Stock	14.11%	13.43%	17.42%	15.96%	14.51%	13.66%	11.20%
C-1O - Asset Risk - All Other	32.41%	33.87%	31.24%	30.43%	30.57%	31.35%	33.83%
C-2 - Insurance Risk	18.53%	19.97%	17.76%	18.93%	18.00%	18.02%	17.43%
C-3A - Interest Rate Risk	9.73%	9.94%	9.37%	11.23%	13.35%	13.82%	13.82%
C-3B - Health Credit Risk	0.00%	0.00%	0.00%	0.00%	0.00%	0.03%	0.03%
C-3C - Market Risk	3.02%	1.04%	1.97%	1.85%	1.73%	0.00%	0.00%
C-4A - Business Risk	5.39%	5.49%	4.50%	4.87%	4.85%	4.85%	4.98%
C-4B - Business Risk Admin. Expenses	0.57%	0.55%	0.47%	0.47%	0.43%	0.60%	0.62%
Total of C-0, C-1 and C-3 elements	75.51%	73.98%	77.27%	75.73%	76.73%	76.50%	76.94%

Source: AGGREGATED LIFE RBC AND ANNUAL STATEMENT DATA

Written Testimony of America's Mutual Banks

Joint Hearing before the
House Financial Services Subcommittees on
Financial Institutions and Consumer Credit
and
Insurance, Housing and Community Opportunity

Examination of the Impact of the Proposed Rules to Implement Basel III Capital Standards

Thursday, November 29, 2012

America's Mutual Banks ("AMB") appreciates the opportunity to provide this testimony to the House Financial Services Subcommittees on Financial Institutions and Consumer Credit and Insurance, Housing and Community Opportunity regarding the joint proposed rules issued by the Federal Reserve Board (the "FRB"), the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation intended to implement the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision (the "Proposals"). AMB is an unincorporated association whose membership consists of banking institutions organized under the mutual form of ownership. AMB's membership consists entirely of community based institutions dedicated to serving their communities and fostering the economic growth of those communities. Community based, mutual form institutions are a historically vital part of the fabric of many communities and their future viability must be protected and enhanced. Unfortunately, as presently proposed, the impact of the Proposals on AMB's members and mutual form institutions generally will be harmful and possible systemically threatening.

In their attempt to address broad market concerns, the Proposals paint with too broad a brush and sweep community based mutual form institutions into the same regulatory scheme as systemically large stock form institutions. Mutual form institutions do not have permanent capital stock like stock form institutions and, therefore, do not have permanent stockholders. We are concerned that the agencies do not truly understand the value, nature and unique role of mutual institutions. We believe that without an in depth understanding, the agencies may miss the impact the Proposals will have on mutual institutions.

While the Proposals present much to comment on we will focus on two primary issues, fluctuations in capital calculations and the need for alternative capital enhancement for mutual institutions.

Capital Calculations. In the Proposals the agencies stated that "Most of the capital of mutual banking organizations is generally in the form of retained earnings (including retained earnings surplus accounts) and the agencies believe that mutual banking organizations generally should be able to meet the proposed regulatory capital requirements". Unfortunately, this statement is premised on a snapshot in time. While generally accurate now, it does not take into account the increased uncertainty and volatility in asset management, earnings and capital calculations which the Proposals themselves create.

The Proposals create the likelihood of wide fluctuations in earnings and capital calculations by institutions. The Proposals provide that unrealized gains and losses on all available-for-sale ("AFS") securities held by an institution would flow to and be included in the calculation of Common Equity Tier 1 Capital ("CET1"). The agencies proffered that such an approach "would better reflect an institution's actual risk". However, the agencies also acknowledged that temporary changes in the market value of securities could create substantial volatility in an institution's regulatory capital ratios, possibly even triggering prompt corrective action. Given the present interest rate environment, it is virtually certain that rates can only rise from where they are today, and that means the market value of securities held will be negatively impacted. Not only can this arbitrary movement (which in most instances the institution has no ability to influence or control) in the market value of securities negatively impact an institution's capital ratios, it quite possibly will negatively affect a mutual community bank's ability to lend and manage its risk. The de-facto mark to market of AFS securities will manifestly increase volatility which will make the capital ratios of mutual community banking institutions fluctuate and harder to maintain. Amplifying the fluctuation of the mutual bank's capital calculations is the provision in the Proposals increasing the risk weighting of various residential and other loans originated and held by institutions. This provision may impact mutual banks more due to the fact that they generally hold loans in portfolio in greater percentages than larger banks and substantially more than the systemic banks. A mutual bank's asset portfolio generally consists of approximately 70% 1-4 family loans compared to approximately 25% for all other financial institutions. This portfolio concentration in mortgages is generally mandated by federal requirements under the qualified thrift lender test and the Internal Revenue Code. An additional element of the Proposals which will negatively impact capital is the full deduction from CET1 of equity investments made by mutual state savings banks in traditional investments which are not permissible for national banks. These investments have been traditionally included in Tier 1 Capital by such institutions. Further, the Proposals capital conservation buffer will restrict discretionary bonuses to executives which is the only means of rewarding successful management of a mutual bank due to the mutual bank not having the ability to provide equity based compensation. As a result of economic and market forces beyond their control, mutual institutions will be forced to adjust their asset portfolio's to account for this increased volatility without the ability to tap the capital markets like stock institutions to support what could very well be more profitable operations. As a result of the increased uncertainty and volatility in asset management, earnings and capital calculations which the Proposals themselves create and without the ability to raise capital beyond retained earnings, many mutual banks may have to curtail growth plans and reduce services to their communities in order to husband capital to meet unexpected future needs which they can neither foresee nor control.

One sure way to avoid the problems discussed above is to exempt mutual institutions from the Proposals entirely. While organized for historically different reasons, mutual form banks and credit unions share a common foundation; they are non-stock form. All credit unions are organized as co-operatives which is essentially the same as the mutual form of organization. However, the Proposals do not apply to credit unions. This irony is an example of the "one size fits all" approach to banks. Credit unions are exempt because there are no systemic aspects relating to them and it is accepted that they did not contribute to the recent banking crisis. Mutual form community banks, the largest of which is one sixth the size of the largest credit union, also are not systemic and did not contribute to the recent banking crisis. Yet, they are being included

in the rules developed for systemically important banking institutions. Thus, exempting mutual banks would be the most sensible and fairest approach.

Alternative Capital Enhancement. If exempting mutual banks is not a viable approach, then the agencies should at least consider an alternative capital enhancement method. As stated above, retained earnings are the primary method by which mutual institutions raise capital. However, the Proposals not only do not provide for alternative methods for mutual banks to raise capital, they will effectively eliminate two long standing and legally permissible capital formation methods available to mutual banks; pledged savings accounts and mutual capital certificates. In light of the foregoing, and notwithstanding that mutual institutions are generally some of the highest capitalized banking institutions, AMB believes that in order to be prepared and to be able to comply with the new and evolving capital standards and changing economic conditions it is imperative to establish alternative methods by which mutual institutions can raise capital which will qualify as CET1 capital. Such capital can be used to grow the institution, expand operations, act as a buffer against the continuing downturn in the economy, finance acquisitions and for other corporate purposes.

The Basel Committee focused almost exclusively on stock form banks in establishing the capital requirements under Basel III. Certain criteria and other terms intended to apply to stock form institutions are not appropriate in gauging the risk profile of mutual form institutions. Ironically, the application of these criteria and terms to mutual banks will increase the risk to the deposit insurance fund rather than decrease it. As stated in footnote 12 on page 14 of Basel III, the Basel Committee acknowledged that it is appropriate for the specific constitution and legal structure of mutual institutions to be taken into account in applying Basel III to them. Effectively, it is being left to national regulators to determine exactly how the new requirements will be applied to mutual institutions. Clearly, the regulators have the latitude to develop a regulatory scheme which does not hinder the viability of mutual institutions, even if it is different from that developed to address large systemic banks.

The European Commission's Capital Requirements Directive IV published in July, 2011 offers a degree of flexibility. This has encouraged central bankers and regulators in the EU to work with and make an effort to accommodate mutual institutions with capital requirements that will comply with Basel III and be compatible CET1 capital.

As was discussed in an article in the American Banker/Bank Think, dated October 3, 2012, perhaps the farthest along are the British Building Societies. The proposal which has emerged is for the issuance of "core capital deferred shares" or CCDS. Nationwide Building Society, Britain's largest, pioneered the way this past May by obtaining approval in principle from the British Financial Services Authority of the CCDS as a CET1 instrument.

What is needed is a proactive collaboration between the FRB, OCC, FDIC and the mutual banking industry, through its representatives such as AMB and the national and state associations, in designing and customizing a CET1 capital instrument for use by mutual institutions. Additionally, all involved in this process must realize that any capital instrument designed to meet the requirements of CET1 must also be marketable and sustainable or the capital enhancement will merely be an academic exercise with no real possibility for successfully

augmenting loss-absorption capital and achieving the goal of stronger institutions and a stronger industry. With that thought in mind, AMB has proposed an alternative capital instrument to be available to mutual institutions. This alternative capital instrument for mutual institutions has enough characteristics under GAAP to qualify as CET1 non-withdrawable capital, which protects the mutual institution and the deposit insurance fund, yet contains no features that are inconsistent with the mutual nature of the institution or jeopardize the tax deductibility of the income payments. The deductibility of the income payments is particularly important to be able to offer an instrument that is economically attractive to both the issuer and the investor. In this regard then, AMB proposes the establishment of a non-withdrawable mutual investment certificate that would have the following characteristics:

- No voting rights, except that holders of the instruments have the right to elect two directors upon the sixth missed interest payment, upon a change of control and upon changes in the capital structure of the bank;
- No holder may put the instrument back to the bank;
- Redemption solely at the bank's discretion;
- Income payable may be fixed or variable or tied to an index;
- Income is payable if and when declared by the board of directors, subject to the capital requirements of the Basel III Proposals;
- Income payments are cumulative;
- Perpetual--no maturity date;
- Repayment is subordinate to the claims of creditors and depositors;
- Convertible into shares of common stock upon a mutual to stock conversion of the bank based on a fixed exchange ratio basis based on the investor's ownership percentage at the time of investment.

AMB believes that adoption of the non-withdrawable mutual investment certificate will safely permit mutual form institutions to enhance capital if it should be necessary while still achieving the agencies objectives of increased loss-absorption capital.

We would note that Congressmen Michael Grimm (R-NY) and Peter King (R-NY) have introduced H.R. 4217, the Mutual Community Bank Competitive Equality Act, which provides, among other things, for authorization for mutual institutions to issue mutual investment certificates which would be eligible for inclusion as Tier 1 Capital.

Conclusion. AMB respectfully requests the Subcommittees to urge the agencies to further investigate the impact of the Proposals on mutual institutions. AMB has a responsibility to its members and to their depositors, members and communities to express its belief that if left unchanged, the Proposals could severely negatively impact the mutual banking industry in this country. AMB strongly believes that by working closely with the agencies, an acceptable resolution can be fashioned. The continuing viability of mutual form institutions should be a common goal which together can be achieved. As discussed above, AMB believes that its

proposal to develop a non-withdrawable mutual investment certificate will enhance significantly the continued vitality of the mutual banking industry and increase the capital cushion protecting the deposit insurance fund.

AMB appreciates the opportunity to provide this testimony to the Subcommittees on this very important issue. We would welcome the chance to further discuss these comments at your convenience.

House Committee on Financial Services

Joint Hearing Before the Subcommittee on Financial Institutions and Consumer Credit and the Subcommittee on Insurance, Housing and Community Opportunity Entitled "Examining the Impact of the Proposed Rules to Implement Basel III Capital Standards"

November 29, 2012

The Council of Federal Home Loan Banks (Council) appreciates this opportunity to submit a written statement for the Subcommittees' consideration in connection with the hearing entitled "Examining the Impact of the Proposed Rules to Implement Basel III Capital Standards". The Council is a trade association whose members are the 12 Federal Home Loan Banks (FHLBanks),[1] and the proposed rules will have a significant impact on FHLBank member institutions as well as the mortgage markets as a whole. The Council is therefore very interested in the Basel III rulemaking proposals and the congressional oversight of their development.

The Council agrees that the capital rules need to be revisited, and that a strong capital buffer is an important safeguard for both individual institutions and our financial system as a whole. Accordingly, the Council supports the underlying goals of the Basel III accord to strengthen the capital base of depository institutions and their holding companies; to provide a buffer against systemic risk; and to better correlate the required amount of capital and the risks presented by particular assets and financial activities. However, for the reasons described below, we are unable to support the rules as proposed. We have attached to this statement a copy of the comment letter we submitted to the regulatory agencies concerning these proposed rules.

I. Risk Weight for Mortgages Held in Portfolio

We are concerned that the proposed capital treatment of mortgage loans held in portfolio by community-based institutions is excessive. Under the proposal there would be a significant increase in the minimum capital requirements for both first and second mortgages, up to twice the current requirements, unless the loan-to-value ratio of the mortgage loan is 80 percent or less. As a result, unless a home buyer can put down at least 20 percent of the cost of the home, plus closing costs, the cost of mortgage credit will increase as the mandated capital increases. This will harm both the consumer and the overall economy.

Today, and for the foreseeable future, mortgage underwriting standards are very stringent. Under recent statutory reforms, the federal banking agencies and the Consumer Financial Protection Bureau (CFPB) have many new tools that will significantly raise the credit

[1] Created by Congress in 1932, the FHLBanks are 12 regional banks, cooperatively owned and used to finance housing and economic development. More than 7,700 lenders nationwide are members of the FHLBank System, representing approximately 80 percent of America's insured lending institutions. The FHLBanks and their members have been the largest and most reliable source of funding for community lending for nearly eight decades.

standards utilized in the extension of mortgage credit by regulated financial institutions without the need for across the board higher capital requirements. Mortgages being made today, and that will be made under these new rules, will look much more like the traditional mortgages that were originated prior to 2005. These mortgages have proven to be safe with very low default and foreclosure rates. Burdening these loans with excessive capital requirements will unnecessarily impede the availability of mortgage credit, increase costs to consumers, and hurt our economic recovery. Especially hard hit will be first-time home buyers, who often require high loan-to-value (LTV) lending.

LTV ratio is an important factor in loan performance. A significant cash investment in a home purchase clearly lowers the risk of default and the loss given a default. However, further analysis needs to be undertaken regarding the impact of lower down payments when other factors indicate that the borrower is creditworthy. When other factors indicate that the borrower is a prime credit, the fact that the down payment is less than 20 percent should not automatically push the loan into a higher capital category.

II. Effect of Other Laws and Regulations and Market Conditions

Another concern in the proposal is that it fails to recognize the impact of all of the statutory and regulatory changes that have been adopted or that are expected to be adopted shortly. The CFPB is currently promulgating regulations to implement the requirement of the Dodd-Frank Act that prohibits a creditor from making a mortgage loan without considering the ability of the borrower to repay. These regulations will effectively require that lenders use very conservative mortgage underwriting standards, or face potential liability for failure to consider adequately repayment ability when originating the loan. The Dodd-Frank Act also requires regulators to implement new rules relating to the securitization of mortgage loans. These regulations will define a "qualified residential mortgage" which will likely become the standard for all new mortgages that are going to be placed into securitization vehicles. These regulations will also require stringent loan underwriting. The CFPB is given broad powers to regulate mortgage originators, including restrictions on incentive compensation. All of these new mandates will significantly raise the credit standards utilized in the extension of mortgage credit by regulated financial institutions. In establishing new capital rules, it is critically important to consider these new laws and regulations, both in terms of the quality of mortgages that will be originated going forward, and also in the cumulative impact these new rules will have on mortgage availability and cost. We are concerned that the cumulative effect of the proposed capital requirements coupled with the other new statutory and regulatory requirements could result in an adverse impact on mortgage availability and affordability.

III. Balloon Payments

Under the proposal, loans that have balloon payment features are subject to more onerous capital requirements. Many of our member institutions, including community financial institution members, view balloon loans as an effective way to provide low cost mortgages to their customers. Many customers desire these loans because they know in advance that they will be moving within a prescribed number of years, or for other legitimate reasons. For community-

based lenders, the use of these products has not been problematic. We also note that from an asset-liability management perspective, community banks are more readily able to retain balloon mortgages on their balance sheet, reducing the need for securitization. Retention of the mortgages on balance sheet also provides a strong incentive for community banks to effectively and prudently underwrite and manage the risks in these loans.

Congress specifically recognized the importance of these loans in rural and agricultural communities and created an exception in the Dodd-Frank Act's qualified mortgage standard for balloon loans made by lenders in these communities. We urge that any final capital rule treat well underwritten balloon loans like any other first mortgages, especially if such loans are written by lenders in rural or agricultural areas.

IV. Home Equity Lines of Credit and Second Liens

During the past decade, some borrowers avoided making any meaningful down payment towards the purchase of the home by using a second loan. These so-called "piggy back" loans increased the risk to the lender. However, home equity lines of credit (HELOC) and second liens that are not used for the purpose of funding down payments are an important source of financing for home improvement projects, medical expenses, educational payments, and paying off more expensive credit card debt. Under the proposal, junior liens are subject to more stringent capital requirements, which can double the capital required under current rules.

V. Commercial Real Estate

The proposal would increase the risk weight of certain commercial real estate loans from 100 percent to 150 percent. The increased risk weight would apply to so-called High Volatility Commercial Real Estate (HVCRE) exposures: loans for the acquisition, development and construction of multi-family residential properties and commercial buildings. The higher risk weight would *not* apply to loans made for the development and construction of 1-4 family residential units.

Commercial real estate lending is very important to our community bank members to support their local communities. We understand that this can be a volatile asset, and that during the financial crisis these loans deteriorated, but not across the board for every community bank. Recent indications are that this market is recovering, underwriting standards have improved, and there is a significant need for credit in this sector. The regulators have numerous tools to prevent a deterioration in underwriting standards, and the use of these tools would be a more effective means of addressing the potential risks in this type of asset than raising the capital charge for these loans without regard to the quality of the loan. Further, it makes little sense to have a higher capital charge for a secured loan (150 percent) than the capital charge that would result from making an unsecured loan to the same builder.

VI. Mortgage Servicing Rights

Another area of our concern is the treatment of mortgage servicing rights (MSRs). These are valuable assets that produce a stream of income that can contribute to the health of our financial institutions. Under current rules the value of these assets is marked to market quarterly, and the market value is then haircut by 10 percent.

We understand that MSRs are sensitive to changes in interest rates, prepayment rates and foreclosure rates. However, they are nevertheless a valuable asset that can be sold in a liquid market. Under the proposal these assets would essentially be driven out of the banking system, to the detriment of both consumers and insured institutions and their holding companies. We believe that the proposed treatment needs to be reevaluated to ensure that it will not result in harming our institutions rather than protecting them.

We recommend that the agencies' concerns with regard to MSRs focus on the quality of the loans associated with the servicing rights, and not lump all MSRs together. If the underlying loans are prudently underwritten the associated MSRs should be allowed to count as an asset for up to 100 percent of Tier 1 capital. If the underlying loan does not meet this standard, a more stringent limit on the associated MSRs may be appropriate.

VII. Securitization Issues

The proposal does not change the treatment of MBS that are issued or backed by a U.S. agency (zero-percent risk weight), or MBS that are issued or backed by Fannie Mae or Freddie Mac (20 percent risk weight). However, the proposal makes significant changes in the treatment of private label MBS, that will make it much more difficult for community banks to purchase private label MBS, and increase the capital charge for those that do. This result will unnecessarily impede the return of private capital to the mortgage markets.

VIII. Inclusion of AOCI in Calculation of Tier 1 Capital

The "minimum regulatory capital ratios, capital adequacy" proposal would require that unrealized gains and losses on securities held as "available for sale" (AFS) be reflected in a banking organization's capital account. The inclusion of these unrealized gains and losses creates the potential for several unintended consequences.

Community banks holding interest rate sensitive securities for asset-liability management or other sound business reasons, would see changes to their capital ratios based solely on interest rate movements rather than changes from credit quality, without commensurate change in capital ratios resulting from movements in the market price for other assets classes or long term or structured liabilities.

Community banks would be incented to hold short term or floating rate securities to minimize the impact on their capital ratios from changes in interest rates. Although there could be beneficial reasons for holding longer term fixed rate assets such as municipal or mortgage securities, banks could be hesitant to do so realizing the long term, fixed rate nature of these investments would subject them to increased price sensitivity and impact on their Tier 1 capital.

Community banks would be incented to hold their securities in "held to maturity" category rather than available for sale to avoid the impact on their capital ratios. This would adversely affect a bank's ability to manage its balance sheet to respond to growing loan demand or changing economic fundamentals.

The inclusion of unrealized gains and losses in AFS securities would diminish the relevance and transparency of the Tier 1 capital measure due to institutions receiving inflated levels of Tier 1 capital from declining interest rates (and hence) rising market values of fixed

rate, non callable securities. This change in capital could overstate the amount of Tier 1 capital if the subject bank had no intention of monetizing the gain on the securities; this could be the case in a scenario where economic activity is stagnant resulting in falling interest rates.

IX. Disparate Competitive Impacts

As discussed above, we believe that the proposal will impose capital charges that are far in excess of the actual risks presented, especially for mortgages written since the financial crisis of 2008. As a result, non-regulated lenders will be able to gain market share at the expense of regulated banking institutions. Making this problem more severe, the bifurcated capital approach (standardized vs. advanced) creates the potential for significant disparate competitive impacts across the two approaches. The significant differences in capital requirements across the advanced and standardized approaches will almost certainly negatively impact community financial institutions as they compete with larger institutions in low credit risk portfolios like traditional mortgages.

X. Conclusion

The Council supports the efforts of the federal regulators to enhance regulatory capital requirements for insured depository institutions and their holding companies. However, overall we are unable to support these rules as proposed. We believe that any increased risk weight must be appropriately aligned with the actual risk presented by the asset. High capital for non-traditional or poorly underwritten loans makes sense, and we support that policy. However, applying higher capital charges for traditional and prudently underwritten mortgages would be extremely counterproductive to our economy and to the American consumer.

Thank you for the opportunity to include our views in the hearing record. If you have any questions, please contact me at the Council's Washington office.

John von Seggern
President and CEO
Council of Federal Home Loan Banks

Attachment

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FHLBANKS
A NATION OF LOCAL LENDERS

October 22, 2012

Mr. Robert deV. Frierson
Secretary, Board of Governors of the Federal Reserve System
20th St. and Constitution Avenue, N.W.
Washington, D.C. 20551
RE: Docket NoR-1430; RIN No. 7100 AD 87 and Docket NoR-1442; RIN No. 7100 AD 87

Mr. Robert E. Feldman
Executive Secretary
Attention; Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
RE: RIN 3064-AD 96 and RIN 3064-AD 95

Office of the Comptroller of the Currency
250 E Street, S.W., Mail Stop 1-5
Washington, D.C. 20219
RE: Docket ID OCC-2012-0009 and Docket ID OCC-2012-0008

Re: Standardized Approach for Risk Weighted Assets; Market Discipline and Disclosure Requirements

Re: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action

Dear Sir or Madam:

I am submitting this comment letter on behalf of the Council of Federal Home Loan Banks (Council). The Council appreciates the opportunity to comment on two notices of proposed remaking ("NPR" or "Proposals") that are designed to implement the Basel III capital framework and make other changes to U.S. capital rules. The first NPR, denominated "Standardized Approach," is the focus of the majority of our comments. We will indicate in the body of the letter the comments that are directed at the accompanying notice (Minimum Regulatory Capital Ratios, Capital Adequacy).

The Council appreciates the need to revisit the capital rules applicable to U.S. depository institutions and holding companies. As the financial crisis made clear, a strong capital buffer is a necessary safeguard for both individual institutions and our financial system as a whole. The Council agrees with the underlying goals of Basel III to strengthen the capital base of depository institutions and their holding companies; provide a buffer against systemic risk; and better correlate the required amount of capital and the risks presented by particular assets and financial activities. The concept of adjusting regulatory capital requirements to risk has been a key goal of our regulatory capital system since the implementation of the original Basel Accord in 1989. One of the most important reforms made by the Basel III revision is to require the use of more sensitive measures of risk when establishing minimum capital levels for the internationally active banking organizations that are subject to the so-called "advanced approach."

We are concerned, however, that the regulatory proposals, and in particular the provisions relating to the treatment of mortgage loans held by community-based institutions, fail to accurately align required capital and the credit risks presented by mortgage loans made since the financial crisis. We have a number of other concerns with the proposals, including the proposed treatment of private label mortgage-backed securities, other issues relating to securitization, mortgage servicing rights, commercial real estate lending, and the inclusion of Accumulated Other Comprehensive Income (AOCI) in the calculation of Tier 1 capital. All of these issues and others will be addressed in more detail below.

I. Mortgages Held In Portfolio Will Be Subject to Significantly Higher Capital Charges

Under current risk-based capital rules, a prudently underwritten mortgage loan, with a loan-to-value (LTV) of 90 percent or less, is assigned a risk weight of 50 percent. The current rules also consider private mortgage insurance as a substitute for part of the cash down payment. As a result, a borrower can combine a small down payment with private mortgage insurance in order to meet the 90 percent LTV standard. Likewise, by statute, both Fannie Mae and Freddie Mac consider the existence of private mortgage insurance as an alternative to meeting those companies' LTV requirements.[1]

Pursuant to the NPR, mortgages are divided into two categories, and then subdivided based on the LTV of the mortgage. Unlike the current rules, private mortgage insurance does not count when determining LTV. Therefore, a home buyer with a 10 percent cash down payment who obtains mortgage insurance on the loan will be considered as having a 90 percent LTV for regulatory capital purposes, notwithstanding the mortgage insurance protection.

Category 1 mortgages have lower capital charges than Category 2 loans. In order to be a Category 1 loan, the mortgage must be a first mortgage, may not exceed 30 years, and cannot have a balloon payment or negative amortization feature. The borrower's income must be verified. If it is an adjustable rate mortgage, any increase in the interest rate cannot exceed two percent per year, or six percent over the life of the loan. Most importantly, the creditor must make a reasonable determination that the borrower can repay the loan based on the maximum interest rate possible during the first five years of the obligation. These requirements are very

[1] Section 305(a) (2) of the Federal Home Loan Corporation Charter Act and Section 302(b) (2) (C) of the Federal National Mortgage Association Charter Act.

similar to the recently proposed definition of a "Qualified Mortgage," (QM) under section 1412 of the Dodd-Frank Act.[2] All other mortgage loans are Category 2 loans.

The risk-weight is then determined by looking at the LTV. For Category 1 loans, the following risk-weights apply:

LTV	Risk Weight
Equal to or less than 60%	35%
Greater than 60% but equal to or less than 80%	50%
Greater than 80% but equal to or less than 90%	75%
Greater than 90%	100%

For Category 2 loans the following risk weights apply:

LTV	Risk-Weight
Equal to or less than 80%	100%
Greater than 80% by equal to or less than 90%	150%
Over 90%	200%

II. Category 1 Mortgages Are Safe and Sound Loans

Historically, mortgage lending has been a safe and sound activity presenting very low credit risk to banking institutions. Until the recent period of high defaults and foreclosures following the initiation of the financial crisis, default rates on residential mortgages were exceedingly low. According to Federal Reserve Board data, from 1991 through 2005 the charge off rate on mortgage loans held by all commercial banks was never higher than .45 percent, and typically was much lower.[3] Delinquency rates on loans held by commercial banks during this period were likewise low, generally between two and three percent.[4] However, beginning in the early 2000s, lenders (primarily unregulated mortgage companies) began originating vast numbers of so-called Alt-A and subprime loans, often with one or more non-traditional terms such as: *no* down payment requirement; principal balances in excess of the market value of the home; low- or no-documentation requirement; very low initial rate for two or three years followed by a large jump in the applicable interest rate; deferred payments or interest-only payments, or negative amortization.[5] Ultimately, these loans began to default in record numbers.[6]

There is no question that the LTV ratio is an important factor in loan performance. A significant cash investment in a home purchase clearly lowers the risk of default and the loss given a default. However, the available evidence indicates that the proposed risk weights for

[2] The major differences between the two requirements are that with the Qualified Mortgage points and fees are limited to three percent, and the mortgage underwriting must comply with any debt to income or residual income guidance that may later be issued by the prudential regulators. 76 Fed. Reg. 27390 (May 11, 2011).
[3] http://www.federalreserve.gov/releases/chargeoff/chgallnsa.htm
[4] Id.
[5] Board of Governors of the Federal Reserve System, *The Federal Reserve and the Financial Crisis* at 8-12 (2012).
[6] Although (as noted below) recent studies have shown that loans that used these nontraditional terms and non-traditional underwriting standards have experienced increased default rates, it should also be noted that investors have filed complaints asserting that mortgage companies and other lenders originating these non-traditional loans did not adhere to stated underwriting standards.

Category 1 mortgages with an LTV in excess of 80 percent are not warranted. Category 1 mortgages are, by definition, similar to the traditional mortgages that were fully documented and underwritten according to historical standards. And because regulated financial institutions will have to determine independently that the borrower has a reasonable "ability to repay" the loan, according to its terms, when the loan is made, it is likely that Category 1 mortgages will be subject to even more stringent underwriting than loans made before the subprime boom. In this regard it is important to note that the requirement to make this independent "ability to repay" determination is not presumed to have been met if the loan also meets the requirements for a qualified mortgage (QM). Thus a lender would have to make an "ability to repay" determination for all Category 1 loans, including qualified mortgages.[7]

In light of the characteristics of Category 1 mortgages it can be expected that these loans will have, at worst, the same performance characteristics of loans made in the early 2000s. Low down payment loans (loans with an LTV in excess of 80 percent) made up a substantial percentage of loans made before the subprime boom. For example, in the years 2001 - 2004, approximately 40 percent of the single-family loans purchased by the GSEs had LTVs in excess of 80 percent.[8] For first-time home buyers the percent of high LTV lending is greater. Low down payment mortgages constituted the *majority* of the financing for first-time home buyers in every year since 1990.[9]

Historically, these loans (including loans with LTVs in excess of 80 percent) performed well.[10] The delinquency rates for single- family mortgages purchased by the GSEs were less than 1 percent for every year between 1988 and 2005.[11] As noted earlier, the delinquency rates on residential mortgages held in portfolio by U.S. banks were also exceedingly low in the years prior to 2005. Based on the performance of mortgage loans at the time, the Basel Committee recommended a risk weight of 35 for residential mortgages under the Basel II standardized approach issued in 2004.[12] The Basel Committee has not amended this recommendation as part of the Basel III revisions. In 2011, the Center for Responsible Lending conducted a review of mortgage loan performance and concluded "badly structured loans and lack of underwriting, *not low down payments*, caused the foreclosure crisis."[13] A logistical regression analysis performed in 2011 by Genworth Financial Corporation using CoreLogic data for 2000-2008 found that the loan terms with the greatest correlation with performance were related to loan amortization (whether a loan is an interest- only loan or a negative amortization loan), and that the amount of the down payment (evaluated in 1% increments) was only the sixth most significant variable. Although we have not conducted our own analysis of this data, these studies conclude that

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[7] We question whether this represents good policy. A better approach would be to consider all QM loans as Category 1 and also subject to the presumption that the ability to repay test has been satisfied.

[8] Department of Housing and Urban Development, *Profiles of GSE Mortgage Purchases: 2001-04* at Table 10. Attached as Exhibit A.

[9] J. Duca, J.Muellbauer and A. Murphy, Federal Reserve Bank of Dallas, *Shifting Credit Standards and the Boom and Bust in U.S. House Prices: Time Series Evidence from the Past Three Decades* 31 (2012).

[10] According to economist Mark Zandi, "While there is no question that larger down payments correlate with better loan performance, low down payment mortgages that are well underwritten have historically experienced manageable default rates, even under significant economic or market stress." Mark Zandi, *Special Report: The Skinny on Skin in the Game*, Moody's Analytics (March 11, 2011).

[11] Office of Federal Housing Enterprise Oversight, *Annual Report to Congress*, Table 9 and 19 (June 15, 2006).

[12] Basel Committee on Bank Supervision, International Convergence on Capital Methods and Capital Standards (Basel II) (Rev. June 2006).

[13] Center for Responsible Lending, Comment Letter submitted to the federal banking agencies on Interagency Proposed Rule on Credit Risk Retention (August 1, 2011).

various non-traditional loan terms and weak underwriting have a stronger correlation with loan defaults than the amount of the down payment.

Category 1 mortgages are safe and sound loans that should have similar, if not better performance characteristics as the mortgages that were made before the subprime boom. These loans included millions of high LTV mortgages that performed well. Any change in the current capital rules should be based on the performance of well underwritten traditional mortgages, and should exclude mortgages that have non-traditional structures or followed nontraditional underwriting standards, such as without documentation of the borrower's resources. We believe that the performance data for high LTV pre-2002 loans demonstrate that the proposed risk weights for mortgages with LTV ratios in excess of 80 percent are too high. We urge the regulators to revisit the proposal in order to ensure that the regulatory capital charge is aligned with the economic risk of Category 1 loans that have LTV ratios in excess of 80 percent.

III. Effect of Other Laws and Regulations and Market Conditions

Another shortcoming in the proposed capital regulation is that it fails to recognize fully the impact of all of the statutory and regulatory changes that have been adopted or that are expected to be adopted shortly. The Dodd-Frank Act prohibits a creditor from making a mortgage loan without considering the ability of the borrower to repay.[14] And the Consumer Financial Protection Bureau (CFPB) is currently promulgating regulations to implement this requirement. These regulations will effectively require that lenders use very conservative mortgage underwriting standards,[15] or face potential liability for failure to consider adequately repayment ability when originating the loan. The Dodd-Frank Act also requires regulators to implement new rules relating to the securitization of mortgage loans.[16] These regulations will define a "qualified residential mortgage" which will likely become the standard for all new mortgages that are going to be placed into securitization vehicles.[17] These regulations will also require stringent loan underwriting. The CFPB is given broad powers to regulate mortgage originators, including restrictions on incentive compensation.[18] All of these new mandates will significantly raise the credit standards utilized in the extension of mortgage credit by regulated financial institutions. In establishing new capital rules, it is critically important to consider these new laws and regulations, both in terms of the quality of mortgages that will be originated going forward, and also in the cumulative impact these new rules will have on mortgage availability and cost. We are concerned that the cumulative effect of the proposed capital requirements coupled with the other new statutory and regulatory requirements could result in an adverse impact to mortgage availability and affordability.

Even without these new laws and regulations, the evidence from the market is quite clear. Unlike the experience of the last decade, in which qualifying for a mortgage loan was easy, it is currently very difficult to qualify for a mortgage loan. Banks and other lenders are demanding far higher credit quality than they did even before the early 2000s.[19] The problem for our

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[14] See Title XIV, Subtitle B of the Dodd-Frank Act.
[15] 76 Fed. Reg. 27390 (May 11, 2011).
[16] Section 941 of the Dodd-Frank Act.
[17] 76 Fed. Reg. 24090 (April 29, 2011).
[18] Semi-annual Report of the CFPB, *Significant Rules, Orders and Initiatives*, (July 2012).
[19] Joint Center for Housing Studies Harvard University, *The State of the Nation's Housing* 2012 at 19.

economy is not unsafe mortgage lending but the reluctance of private capital to enter the market. Higher capital requirements will only further reduce the availability of mortgage credit.

Concerns that mortgage underwriting standards may decline in the future are also misplaced. If there were ever an attempt to return to the home loan financing practices of the mid-2000s, the regulators have a broad array of new tools at their disposal to stop these practices.[20] In addition, the Financial Stability Oversight Council (FSOC) has the authority to determine that any financial practice presents risks to the U.S. financial system, and can request that the appropriate federal agency implement steps to prevent or curtail that activity.[21] This authority is not limited to large institutions, and thus the FSOC can use its influence to curtail risky practices conducted by any financial company without regard to asset size.

Regulatory tools, including the ability to raise underwriting standards immediately through regulatory guidance, should mitigate the concerns that the experience of the past decade will be repeated. Utilization of these regulatory tools to address risky lending practices is more effective than raising capital standards on all mortgage loans that have an LTV in excess of 80 percent, which would raise the cost of mortgage loans for all but the wealthiest segments of our country, and limit the ability of credit-worthy, first-time home buyers and minorities to obtain mortgage loans.[22]

IV. Balloon Payments

Another issue raised by the proposal is the blanket prohibition on balloon payment loans in Category 1. The Council believes there are balloon payment loans that are appropriate to a borrower's needs and repayment abilities and should be considered for Category 1 treatment with a risk weighting that addresses associated risk. Many of our member institutions, including community financial institution members, view balloon loans as an effective way to provide low cost mortgages to their customers. Many customers desire these loans because they know in advance that they will be moving within a prescribed number of years, or for other legitimate reasons. For financial institutions that have applied appropriate underwriting standards, particularly community- based lenders, the use of these products has not been problematic. We also note that from an asset-liability management perspective, community banks are more readily able to retain balloon mortgages on their balance sheet, reducing the need for securitization. Retention of the mortgages on balance sheet also provides a strong incentive for community banks to effectively and prudently underwrite and manage the risks in these loans.

Congress specifically recognized the importance of these loans in rural and agricultural communities and created an exception in the Dodd-Frank Act's qualified mortgage standard for

[20] The federal banking agencies are empowered to issue enforceable real estate lending standards under section 304 of the Federal Deposit Insurance Corporation Improvement Act. The agencies are also authorized to increase required capital levels on an institution specific basis when they find that increased capital is required in light of the activities and assets of that institution. 12 U.S.C. § 3907(a) (2). See, e.g.. 12 C.F.R. § 3.9 ("The OCC is authorized ... to establish such minimum capital requirements for a bank as the OCC, in its sole discretion, deems appropriate in light of the particular circumstances of that bank."

[21] Section 120 of the Dodd-Frank Act.

[22] Increasing the capital charge, and thus the cost, for mortgage loans with an LTV in excess of 80 percent will hurt all first-time home buyers that predominately rely on lower down payment mortgages. However, minorities as a group will be hardest hit. According to data from the American Housing Survey, 72 percent of African-American buyers and 63 percent of Hispanic buyers took out mortgages that were above 90 percent LTV in 2009.

balloon loans made by lenders in these communities.[23] We urge that any final capital rule treat well underwritten balloon loans as for Category 1 mortgages, especially if such loans are written by lenders in rural or agricultural areas.

V. Home Equity Lines of Credit and Second Liens

During the past decade, some borrowers avoided making any meaningful down payment towards the purchase of the home by using a second loan. These so-called "piggy back" loans increased the risk to the lender. However, home equity lines of credit (HELOC) and second liens that are not used for the purpose of funding down payments are an important source of financing for home improvement projects, medical expenses, educational payments, and paying off more expensive credit card debt. Under the proposal, all junior liens are considered Category 2 loans, unless the same party holds both the first and second exposure.[24]

The interest rate on home equity lines is typically indexed, but not capped. In addition, home equity lines of credit often allow the homeowner the option to make interest- only payments for an established period of time. Under the proposal the existence of either of these features would result in classifying a home equity line as a Category 2 loan. Thus, even if the HELOC is in a first lien position, or is held by the same lender who holds the first loan, the home equity line would be a Category 2 exposure.

As Category 2 loans, both HELOCs and second mortgages would have twice the capital charge as would be imposed on a first lien with a similar LTV. Even worse, if the second lien or HELOC does not qualify for Category 1 treatment, for example because it has a balloon feature or because its interest rate is not capped, and both loans are held by the same bank, the entire exposure (both the first loan and the second or HELOC) is treated as a Category 2 mortgage asset.

The proposal fails to distinguish between traditional variable rate loans and the much more troublesome teaser loans with an artificially low teaser rate for two or three years followed by a high jump in the interest rate resulting in "payment shock" to the borrower. Traditional variable rate loans, such as an underwritten 5/1 or 7/1 product, have been demonstrated to be both safe for the lender and useful to the consumer. Clearly there are many other well underwritten variable rate loans that should not be lumped into Category 2 because of the poor performance of the non-traditional 2/28 and 2/27 teaser products. Moreover, from an interest rate risk perspective, 5/1 or 7/1 mortgages, as examples, are likely to be more readily and effectively hedged by a financial institution than might be the case with a 30-year mortgage.

In short, the risk weight of home equity lines and other second mortgages that are made in conformance with traditional and prudent underwriting standards (including consideration of the combined first and second liens for LTV exposure purposes, and a determination that the borrower has the ability to repay both loans) should be adjusted to reflect the actual risk of the second loan or home equity line of credit. Simply doubling the risk weight from current rules does not appear to reflect the actual increase in risk.

VI. Commercial Real Estate

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[23] Section 1412 of the Dodd-Frank Act.

[24] Category 1 treatment is allowed if the same lender holds both the first lien and the second lien or HELOC, with no intervening liens. The lender combines the two exposures to determine the LTV of the combined loan. If both exposures meet the requirements for Category 1, the combined loan will qualify for Category 1 treatment. But if either loan does not meet the standards for Category 1, both loans are treated as Category 2 exposures.

The proposal would increase the risk weight of certain commercial real estate loans from 100 percent to 150 percent. The increased risk weight would apply to so-called High Volatility Commercial Real Estate (HVCRE) exposures: loans for the acquisition, development and construction of multi-family residential properties and commercial buildings. The higher risk weight would *not* apply to loans made for the development and construction of 1-4 family residential units.

Commercial real estate lending is a significant source of income for many of our community bank members. We understand that this can be a volatile asset, and that during the financial crisis many of these loans went bad. However, recent indications are that this market is recovering, underwriting standards have improved, and there is a significant need for credit in this sector. The regulators have numerous tools to prevent deterioration in underwriting standards, and the use of these tools would be a more effective means of addressing the potential risks in this type of asset than raising the capital charge for these loans without regard to the quality of the loan. Further, it makes little sense to have a higher capital charge for a secured loan (150 percent) than the capital charge that would result from making an unsecured loan to the same builder.

VII. Mortgage Servicing Rights

The term "mortgage servicing rights" (MSRs) refers to the right to service a mortgage by collecting monthly payments, managing the escrow, paying taxes and other fees, and dealing with delinquent loans and loans in foreclosure. These rights arise when a mortgage loan is sold but the servicing is retained by the loan originator or sold to a third party. For example, a community bank may want to sell a loan into a securitization pool, but retain the right to service the loan in its local community. Also, a small bank may wish to originate loans but sell the servicing to a larger institution that has the appropriate infrastructure to service the loan efficiently.

Under current rules, mortgage servicing rights may be treated as an asset of a bank in amounts up to 100 percent of the bank's Tier 1 capital. The value of the bank's MSRs must be reduced to 90 percent of fair market, and adjusted quarterly. The "minimum regulatory capital ratios, capital adequacy" proposal would reduce the amount of MSRs that may be included as a bank asset to 10 percent of the bank's common equity Tier 1 capital, and the remainder would have to be deducted from capital. Under the "standardized approach" NPR, the MSRs that are not deducted would have to be risk weighted at 250 percent. In essence, under the proposed treatment many banking organizations would likely leave this market, and the mortgage servicing function would move to nonbanking entities.

While mortgage servicing rights are sensitive to changes in interest rates, prepayment rates and foreclosure rates, they are nevertheless a valuable asset that has performed well prior to the financial crisis. These assets can be sold in a liquid market and can be used to support a bank's other activities. [25] Driving this asset out of the banking system will greatly decrease the

[25] See, e.g. Testimony of FDIC Chair Sheila Bair, Hearing on Implementing the Dodd-Frank Act, Before the Senate Comm. On Banking, Housing and Urban Affairs, 111th Cong. 2d Sess. 67 (2010)(While the value of mortgage servicing rights can be volatile, they clearly have value); Testimony of Federal Reserve Board Tarullo, Hearing Before the Subcommittee on Security and International Trade of the Senate Comm. on Banking, Housing and Urban

number of companies able and willing to perform this activity, and thereby raise the cost of servicing for the public, and deprive regulated financial companies of a stream of revenue that can be used to support other lending activities. The net effect will be to increase the cost of mortgage loans.

Because MSRs gain value when interest rates increase, this asset acts as a natural hedge against interest rate risk. If MSRs are forced out of the banking system, banks will either have more exposure to the risks of increased interest rates, or will have to purchase swaps and other hedges at an increased cost to the institution, and ultimately to the public.

We are well aware that in recent times MSRs suffered significant declines in value due to the large number of delinquencies, defaults and foreclosures. All of these events raise the cost of servicing. In addition, when a loan is refinanced the servicing fee for that loan is terminated. However, the capital rules should be forward looking, and not based on the unique circumstances of the past few years. As previously noted, on a going forward basis home mortgages will be underwritten, and will likely perform, according to historical norms. In the 1990s, the regulatory agencies increased the amount of MSRs that could be counted as an asset from 50 percent to 100 percent of Tier 1 capital.[26] At that time the agencies expressed the view that the requirement to haircut this asset by 10 percent, and determine its fair market value on a quarterly basis, would provide sufficient safety to enable banks to hold MSRs in an amount of up to 100 percent of Tier 1 capital.

We recommend that the agencies' concerns with regard to MSRs focus on the quality of the loans associated with the servicing rights, and not lump all MSRs together. If the underlying loans are prudently underwritten (*i.e.*, if they meet the QM standards that will soon be released), the associated MSRs should be allowed to count as an asset for up to 100 percent of Tier 1 capital. If the underlying loan does not meet this standard, a more stringent limit on the associated MSRs may be appropriate.

VIII. Securitization Issues

Under the capital rules in effect today, mortgage-backed securities (MBS) that are issued or backed by an agency of the United States, such as GNMA, are given a zero-risk weight. MBS issued by a Government-Sponsored Enterprise, such as Fannie Mae or Freddie Mac are assigned a 20 percent risk weight. Private label MBS are assigned a risk-weight based on the credit rating of the position. For example, securities in the highest or next highest grade (AAA or AA) have a risk weight of 20 percent. Securities in the third highest grade (A) have a risk weight of 50 percent.

The proposal does not change the treatment of MBS that are issued or backed by a U.S. agency (zero-percent risk weight), or MBS that are issued or backed by Fannie Mae or Freddie Mac. However, the proposal makes significant changes in the treatment of private label MBS.

For private label securities the proposal does away with reliance on credit ratings,[27] and instead will require the investing bank to undertake its own due diligence of the credit risks

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Affairs, 111th Cong. 2d Sess. 16 (July 20, 2011)(Mortgage servicing rights, again, are not the same as an asset already on the balance sheet, but they are an expected stream of earning which have performed well in the past)

[26] 63 Fed. Reg. 42669 (Aug. 10, 1998).

[27] Under section 939A of the Dodd-Frank Act the regulatory agencies are required to end the use of credit ratings for regulatory purposes.

involved, and demonstrate to the bank's examiner a comprehensive understanding of the structure and risks of the security. The due diligence must include an analysis of the features of the securitization that could materially affect performance, including the cash flow waterfall, triggers, credit enhancements, and the specific definitions of default used in the securitization.

A bank would also be required to consider relevant information about the performance of the underlying securities, market data, price volatility, trading volume, liquidity support, percentage of loans that are 30, 60 and 90 days past due, loans in foreclosure, overall default rates, occupancy data, average LTV of the underlying loans, average credit scores of the borrowers, the extent of the geographic diversification of the loans and size, depth and concentration of the market for the securitization including bid-ask spreads. The bank's analysis must be conducted and documented prior to the purchase of the instrument. If the bank cannot demonstrate such a comprehensive understanding, it would be required to risk weight the exposure at 1,250 percent.

Based on the bank's analysis, the appropriate risk weight for the security would be determined using one of two prescribed models in the regulation.

With respect to banks selling mortgages into a securitization pool, the "minimum regulatory capital ratios, capital adequacy" NPR requires the selling bank to deduct from Tier 1 regulatory capital any non-cash gain on sale that would be recognized under generally accepted accounting principles, and apply a risk weight of 1,250 percent to any credit enhancing interest only securities generated by the securitization.

We agree with the proposal that the risk weight for mortgage backed securities issued or guaranteed by a U.S. agency and Government-Sponsored Entities should not be changed. However, we are concerned that the proposal inhibits private label securitization by making it very difficult, if not impossible, for community and smaller banks to purchase private label MBS. These institutions simply do not have the capacity to undertake the extensive analysis demanded by the proposal, and thus are likely to be frozen out of the market for these securities. The result will prevent these banks from acquiring higher yielding securities that will be backed by the stringently underwritten mortgages that are now being made.

We understand that under the Dodd-Frank Act the banking agencies can no longer link the risk weight for securities with the credit rating of those instruments. However, expecting small and community banks to engage in a sophisticated analysis of the products is not realistic and will have broader negative consequences for the housing markets. We therefore recommend that for small and community banks the requirement to engage in the extensive due diligence be waived and that a risk weight of 20 percent be assigned to private label MBS provided that all of the loans meet certain underwriting standards. In particular, we suggest that once the QM test is finalized, establishing the regulatory standard for a low risk mortgage, securities backed solely by such mortgages should be assigned a risk weight of 20 percent.

Further, we believe that the purchasing bank should be able to rely on a representation by the securitizer that all the loans qualify, and that the obligation of the purchasing bank be limited to a sampling of the loans. A small or community bank should be able to rely on an independent third party to conduct this sample. Finally, we recommend that the requirement in the "minimum regulatory capital ratios, capital adequacy" NPR that a bank selling loans into a securitization deduct from Tier 1 capital all non-cash gains on sale should be revisited. Rather

than a dollar for dollar deduction, the agencies should consider a supervisory approach in which the value of this asset could be adjusted if the examiner has reason to believe it is not valid.

IX. Repurchase Agreements

Under current rules, capital is required for any on-balance sheet exposure that arises from a repo-style transaction (that is, a repurchase agreement, reverse repurchase agreement, securities lending transaction, and securities borrowing transaction). For example, capital is required against the cash receivable that a banking organization generates when it borrows a security and posts cash collateral to obtain the security. The proposal would impose a capital charge on all repo-like transactions, regardless of whether the transaction generates an on-balance sheet exposure.

Under the NPR, a banking organization would be required to apply a 100 percent conversion factor to off-balance sheet repurchase agreements, securities lending or borrowing transactions, and other similar exposures. The off-balance sheet component of a repurchase agreement would equal the sum of the current market values of all positions the banking organization has sold subject to repurchase.

Repurchase agreements are a key part of the financial management of the Federal Home Loan Bank (FHLBank) system. The proposed rule will increase the capital charge for banks that sell securities to a FHLBank with the obligation to repurchase these securities at a later date. When the FHLBank is a counterparty, there is essentially no risk to the selling bank that the FHLBank will not be able to comply with its obligation to return the securities to the counterparty. We would urge the regulators to provide an exemption from this new capital requirement for off-balance sheet positions held as part of a repo transaction.

X. Swaps

FHLBanks, as well as other financial institutions holding interest rate sensitive assets, engage in derivative transactions to protect against changes in prevailing interest rates. The proposed rule requires banking organizations to hold capital with respect to such derivative agreements, with the amount of the capital charge dependent upon the counterparty, the collateral, and the remaining maturity on the contract. The proposal would not require a capital charge for derivatives cleared through a central clearinghouse. The FHLBanks use a wide variety of swap agreements to hedge the various types of funding that our member banks require, and therefore the use of a clearinghouse is not practicable for all swaps transactions. Further, when the FHLBank is a counterparty, there is essentially no credit risk to the counterparty. We believe that capital should not be charged when the counterparty is a FHLBank, even if a clearinghouse is not used.

XI. Inclusion of AOCI in Calculation of Tier 1 Capital

The "minimum regulatory capital ratios, capital adequacy" NPR would require that unrealized gains and losses on securities held as "available for sale" (AFS) would be reflected in a banking organization's capital account. The inclusion of these unrealized gains and losses creates the potential for several unintended consequences.

Community banks holding interest rate sensitive securities for asset-liability management or other sound business reasons, would see changes to their capital ratios based solely on interest

rate movements rather than changes from credit quality, without commensurate change in capital ratios resulting from movements in the market price for other assets classes or long term or structured liabilities.

Community banks would be incented to hold short term or floating rate securities to minimize the impact on their capital ratios from changes in interest rates. Although there could be beneficial reasons for holding longer term fixed rate assets such as municipal or mortgage securities, banks could be hesitant to do so realizing the long term, fixed rate nature of these investments would subject them to increased price sensitivity and impact on their Tier 1 capital.

Community banks would be incented to hold their securities in "held to maturity" category rather than available for sale to avoid the impact on their capital ratios. This would adversely affect a bank's ability to manage its balance sheet to respond to growing loan demand or changing economic fundamentals.

The inclusion of unrealized gains and losses in AFS securities would diminish the relevance and transparency of the Tier 1 capital measure due to institutions receiving inflated levels of Tier 1 capital from declining interest rates (and hence) rising market values of fixed rate, non callable securities. This change in capital could overstate the amount of Tier 1 capital if the subject bank had no intention of monetizing the gain on the securities; this could be the case in a scenario where economic activity is stagnant resulting in falling interest rates.

XII. Acquired Member Assets

We recognize that, as a conceptual matter, there may be some merit in the proposed rule's approach to RBC requirements for the mortgage programs that have been established by many of the FHLBanks whereby they acquire or fund conventional and government-insured residential mortgage loans originated and serviced by member institutions, known as Acquired Member Assets ("AMA") Programs. These programs operate under the names Mortgage Partnership Finance® ("MPF®") Program[28], first established in 1997, and the Mortgage Purchase Program ("MPP"), established in 2000. By using a unique risk-sharing structure, these programs allow participating members to retain a significant portion of the credit risk of the fixed-rate mortgages they originate when selling conventionally underwritten loans to the FHLBanks. Allocating the risks inherent in long term, fixed-rate mortgages in this manner results in a more efficient and lower cost mortgage financing benefitting American home buyers.

These programs are very popular with smaller community financial institutions because they provide an alternative to the traditional secondary market that can be difficult or prohibitively costly for many community lenders to access. Approximately 1,500 FHLBank member institutions, typically community banks, thrifts and credit unions, have used these programs to fund about $235 billion of mortgages that have helped home buyers in every state, including large numbers of low- and middle- income buyers, purchase a new home or lower the cost of their existing home through refinancing.

The structure of several MPF® products requires a participating member to provide a credit enhancement of a defined portion of a pool of residential mortgage loans that have been delivered to one of the FHLBanks. Even though the loans are held on the balance sheet of the FHLBank, the participating member must hold risk-based capital ("RBC") against its off-balance

[28] "Mortgage Partnership Finance" and "MPF" are registered trademarks of the Federal Home Loan Bank of Chicago.

sheet credit enhancement ("CE") obligation. As we understand the proposed rule, the amount of RBC required for participating members would be changed to more appropriately reflect the risk of potential losses related to the participating members' CE obligation.

Under the "standardized approach" described in the proposed rule, there are three possible definitional paths for a participating members' credit enhancement obligation in the AMA Programs: (1) "traditional securitization"; (2) "synthetic securitization"; and (3) "retail exposure." Based on our analysis, a member's credit enhancement required under the MPF® Program would likely fall into the "synthetic securitization" definition and resulting methodology.

The proposed rule eliminates the existing regulatory approach for RBC that has been in place since the MPF® Program was rolled out to members in 1997, replacing it with a much more conceptually appropriate, albeit complicated, formula. Further, the proposed rule would not grandfather existing MPF® pools under the current RBC rules.

Member credit support obligations in MPP programs are structured differently from those of MPF® products. Participating members' credit support obligations are limited to funding a risk based and FHLBank established Lender Risk Account ("LRA") from the proceeds of the sale of the mortgage loans (a purchase price hold-back) or a portion of the amount of interest paid by the borrower, and to providing supplemental mortgage insurance for some MPP products. Each MPP mortgage pool's LRA is used to reduce or offset credit losses suffered by the pool. No member is obligated to cover credit losses over and above the amount of funds in the LRA. Amounts remaining in the LRA after losses are returned to the participating member according to a predetermined release schedule. The participating member's exposure is therefore limited to the risk it will not receive all (or any) of the LRA, because the MPP FHLBank absorbs any losses in excess of the LRA. However, as in the case of the MPF® products, we understand that the proposed rule would not grandfather existing MPP pools under current RBC rules.

The Council recommends working toward a solution that implements the formula-based approach to determining the RBC requirement related to the member holding the CE obligation without requiring the risk weighting tied to Category 1 loans under the proposed rules. The formula-based approach could fit into the existing RBC framework that recognizes the safe and sound loans being sold into AMA Programs.

Modifying the proposed rule to more appropriately recognize the credit risk members accept by retaining a credit enhancement on high quality residential mortgages will encourage broader participation and the use of private capital to support the residential mortgage markets. However, the proposed rule's highly unfavorable treatment of mortgage servicing rights (as indicated in a previous section of this letter under the heading "VII. Mortgage Servicing Rights") would be very detrimental to the AMA programs, in which FHLBank member institutions generally retain servicing of the loans and thus maintain their relationship with their customers. Moreover, the rules should be simplified to more closely match the existing framework to reduce the risk that smaller community financial institutions might exit the mortgage origination market, which would further concentrate this market into the hands of a few, very large financial institutions and reduce choices for American consumers.

XIII. Disparate Competitive Impacts

One of the primary purposes of the Basel framework was to better align required capital and risk in order to reduce the competitive advantages that capital regulations could provide to different banking organizations. The same principle applies within a single country. When one segment of the financial services industry is required to hold capital that is in excess of the economic risk of its assets, the segments of the industry not burdened by these excessive capital requirements will have a market advantage. Thus it is critical that capital charges be closely aligned to the risk inherent in the portfolios and activities of the institutions subject to those charges.

As discussed above, we believe that the proposal will impose capital charges that are far in excess of the actual risks presented, especially for mortgages written since the financial crisis of 2008. As a result, non-regulated lenders will be able to gain market share at the expense of regulated banking institutions. Making this problem more severe, the bifurcated capital approach (standardized vs. advanced) creates the potential for significant disparate competitive impacts across the two approaches. The significant differences in capital requirements across the advanced and standardized approaches will almost certainly negatively impact community financial institutions as they compete with larger institutions in low credit risk portfolios like traditional mortgages.

XIV. Conclusion

The Council supports the efforts of the federal regulators to enhance regulatory capital requirements for insured depository institutions and their holding companies. However, overall we are unable to support these rules as proposed.

We believe that any increased risk weight must be appropriately aligned with the actual risk presented by the asset. High capital for non-traditional or poorly underwritten loans makes sense, and we support that policy. However, applying higher capital charges for traditional and prudently underwritten mortgages would be extremely counterproductive to our economy and to the American consumer. We therefore urge the regulators to evaluate carefully the need to increase the risk weight of Category 1 mortgages, and to take into account both current underwriting standards and the overlay of regulatory initiatives designed to assure prudent lending in the future.

The Council also urges the regulators to consider placing well underwritten balloon loans, made in rural or agricultural areas, into Category 1, as was done in the Dodd-Frank Act for QM loans.

The proposed increase in capital for high-volatility commercial real estate loans (HVCRE) is another area that should be reconsidered, in light of the changes in both regulatory oversight and the more recent performance of these loans. There is a great need for multi-family housing development, and increasing the capital requirements for these loans may have significant unintended consequences for this sector of the housing market.

Under the proposal, banking organizations would essentially be forced out of the market for mortgage servicing rights. We believe that this result is not in the public interest, and a better approach would be to link the treatment of mortgage servicing to the quality of the associated mortgage loans. For example, MSRs associated with loans meeting a QM standard should be afforded better treatment than other MSRs.

We also believe that the proposed treatment of mortgage securitization needs to be revised. Under the proposal, non-conforming loans would be particularly hard hit, since private label mortgage-backed securities would be significantly disadvantaged.

The Council believes that the higher capital required for reverse repurchase agreements and swap agreements that are not cleared should be revised to take into account situations where a FHLBank is a counterparty.

While as a conceptual matter there may be some merit in the proposed rule's approach to risk based capital requirements for the FHLBanks mortgage programs, known as Acquired Member Assets ("AMA") Programs, the proposed rule's highly unfavorable treatment of mortgage servicing rights would be very detrimental to the AMA programs. Moreover, the rule should be simplified to more closely match the existing framework to reduce the risk that smaller community financial institutions might exit the mortgage origination market, which would further concentrate this market into the hands of a few, very large financial institutions and reduce choices for American consumers.

The significant differences in capital requirements between the standardized and advanced approaches and the likely negative impact of this imbalance on community financial institutions also represent a significant concern. We suggest the standardized rule include a formal and scheduled recalibration of the standardized approach within the parallel reporting period of the advanced approach to achieve a greater degree of alignment and thereby eliminate significant competitive imbalances and other impacts detrimental to the safety and soundness of community financial institutions.

Finally, the proposed capital rule includes Accumulated Other Comprehensive Income (AOCI) in calculating Tier 1 capital. The inclusion of unrealized gains and losses on securities held as "available for sale" in determining Tier 1 capital has the potential to substantially increase the volatility of Tier 1 capital and distort the bank's regulatory capital ratios. Community banks holding interest rate sensitive securities for sound business purposes could see changes to their capital ratios based solely on interest rate changes rather than changes from credit quality.

We thank you again for the opportunity to comment on these proposals.

Sincerely,

Carl Wick

Carl F. Wick
Chairman
Council of Federal Home Loan Banks

M B C A

MID-SIZE BANK COALITION OF AMERICA

Associated Bank
Banco Popular North America
Bank of Hawaii
BOK Financial
City National Bank
Commerce Bancshares, Inc.
East West Bank
FirstBank Holding Company
First Hawaiian Bank
First Horizon National Corporation
FirstMerit Corporation
F.N.B Corporation
Frost National Bank
Fulton Financial Corporation
Hancock Bank
Iberia Bank
MB Financial
Old National
Oak West Bank
People's United Bank
Raymond James Bank
Sterling Bank
Silicon Valley Bank
Susquehanna Bank
TCF Financial Corporation
The Private Bank
Trustmark Corporation
UMB Financial Corporation
Umpqua Bank
Valley National Bank
Webster Bank

November 20, 2012

Mr. Michael S. Gibson
Director, Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Re: Impact of Proposed Capital Rules

Dear Mr. Gibson:

On behalf of the Mid-size Bank Coalition of America ("MBCA"), I am writing to highlight the MBCA's concerns about the proposed capital rules to implement Basel III that would apply to MBCA members if adopted as proposed ("proposed rules"). The MBCA submitted a comment letter on the proposed capital rules to the federal banking agencies (the "Agencies") on October 22, 2012. I have enclosed a copy of that letter.

The MBCA is a non-partisan financial and economic policy organization comprising the CEOs of mid-size banks doing business in the United States. Founded in 2010, the MBCA, now with 31 members, was formed for the purpose of providing the perspectives of mid-size banks on financial regulatory reform to regulators and legislators. As a group, the MBCA banks do business through more than 3,800 branches in 41 states, Washington D.C. and three U.S. territories. The MBCA's members' combined assets exceed $450 billion (ranging in size from $7 billion to $30 billion) and, together, its members employ approximately 77,000 people. Member institutions hold nearly $336 billion in deposits and total loans of more than $260 billion.

The MBCA appreciates the willingness of the Federal Reserve to reconsider provisions in the proposed capital rules that have raised serious concerns among our member banks. We are particularly encouraged by your statement at the Senate Banking Committee's recent hearing on "Oversight of Basel III: Impact of Proposed Capital Rules" that the Federal Reserve is "sensitive to concerns expressed by community banking organizations." We appreciate your specifically recognizing our concerns about the proposed

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treatments of unrealized gains and losses on securities ("AOCI") and the proposed risk-weightings of residential mortgage loans. And we applaud your pledge to be mindful of our comments when you consider changes to the proposed rules.

The MBCA fully supports the fundamental goal of capital adequacy underlying the proposed capital rules, but the cumulative effect of the significant changes in capital and risk weights should be weighed carefully and the potential ramifications well understood. The MBCA has serious reservations regarding the agencies' current proposed treatment and recommends that the agencies instead adopt an approach that recognizes the unique characteristics and role mid-size banks play in the financial system.

I. Treatment of Smaller Banks

At the Senate Banking Committee hearing, as well as in recent public statements, the agencies have indicated a willingness to consider simplifying the application of the proposed rules as they are applied to community banks (generally, those with consolidated assets of $10 billion or less) in recognition of the role these banks play in their communities, particularly in the mortgage lending area. The MBCA urges the agencies to afford mid-size banks (those with total consolidated assets of $10 billion to $50 billion) the same simplified capital treatment as community banks. As discussed below, mid-size banks more closely resemble community banks than large banks in terms of their role in the community and the financial system more broadly. Further, mid-size banks will face a similar and disproportionate compliance burden as community banks when compared to the large banks. Finally, if the capital rules are adopted as proposed, mid-size banks will face strong pressure to consolidate and/or merge with larger institutions, increasing systemic risk and decreasing consumer choice.

Like smaller community banks, mid-size banks primarily serve the communities in which they are located and are critical providers of credit to consumers and small businesses. Mid-size banks, like community banks, maintain limited risk profiles and simplified balance sheets, engage in conservative lending practices and common-sense underwriting, and have far simpler corporate structures compared to large banks with over $50 billion in consolidated assets. As a result, mid-size banks have conservative loan-to-deposit ratios and good credit availability, but far fewer resources to devote to compliance and other administrative costs. Banks under $50 billion in consolidated assets were not responsible for the risky banking practices and asset structures that contributed to the 2008 financial crisis, and no purpose is served by requiring these banks to hold additional capital against risky behaviors in which mid-size banks do not engage. Instead, mid-size banks, like community banks, should be subject to capital rules commensurate with their resources, banking practices, and role in providing credit and other services to their customers.

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If implemented in their proposed form, the Basel III capital rules will place substantial burdens on mid-size and community banks that lack the resources to comply with some of the rules' more complex aspects, such as the new categories for risk-weighting mortgages. These new standards would require a series of complex evaluations of banks' loan commitments and other factors. Although large banks may already undertake such analyses, mid-size and community banks will likely have to undergo significant retooling of their computer systems in order to comply. They may even need to hire additional staff to determine their capital levels on a day-to-day basis, as those levels will be determined by new, more complex and volatile regulatory concepts such as common equity tier 1 capital and the capital conservation buffer. As Senator Patrick Toomey pointed out at the Banking Committee hearing with respect to community banks, these would be "very significant compliance costs for institutions that nobody has ever suggested are systemically significant." The same is true for mid-size banks.

The Basel III framework was designed to harmonize global banking standards applicable to the large, internationally active and systemically important financial institutions. Imposing all the complexities of that framework on banks with assets under $50 billion could have the adverse consequence of increasing systemic risk by effectively forcing those smaller to consolidate and merge with larger institutions. Further, this would accelerate the process of thinning out the community and mid-sized banking sector. For consumers, such thinning-out means fewer alternatives, and likely higher rates on loans and lower rates on deposits. It also means consumers and borrowers will have to deal with a very large bank that may not be familiar with the needs of their community – marking an end of the local connection so many mid-size and community banks have with the customers they serve.

II. Precedent for the $50 Billion Threshold

The approach advocated by the MBCA and community banks is within the authority of the banking agencies under Section 171. Moreover, in other sections of the Dodd-Frank Act, Congress recognized that financial institutions with total consolidated assets of less than $50 billion pose far less risk to the financial system as a whole than those with higher asset levels. The MBCA asks that the agencies recognize this threshold in developing appropriately tailored capital rules as well.

Section 171 of the Dodd-Frank Act requires the agencies to set minimum risk-based capital requirements not less than the generally applicable risk-based capital requirements under the prompt corrective action regulations implementing Section 38 of the Federal Deposit Insurance Act, regardless of total consolidated asset size or foreign financial exposure, nor quantitatively lower than the generally applicable risk-based capital requirements that were in effect for insured depository institutions as of the date of enactment of the Dodd-Frank Act.

While Section 171 sets a quantitative floor, it also provides the agencies substantial flexibility to tailor specific elements of the capital requirements to different institutions based on asset size. In fact, the agencies already have recognized this flexibility in their proposed capital rules – by subjecting only banking organizations with $250 billion or more in total consolidated assets or consolidated total on-balance sheet foreign exposure at the most recent year-end equal to $10 billion or more to separate and additional capital requirements. The MBCA urges the agencies to develop a third, simplified set of capital standards for smaller banking organizations with less than $50 billion in assets. We believe the agencies could do so while maintaining the floor required under Section 171, as they have done with the two approaches in the proposed rules.

Further, other sections of the Dodd-Frank Act recognize the $50 billion threshold as an important indicator of the size and riskiness of banking organizations. Section 165 of the Dodd-Frank Act requires the Federal Reserve to establish prudential standards, including risk-based capital requirements and leverage limits, for bank holding companies with total consolidated assets equal to or greater than $50 billion. Such standards must be "more stringent than the standards and requirements applicable to . . . bank holding companies that do not present similar risks to the financial stability of the United States." This statutory language recognizes the greater risks that large banks pose to financial stability and requires different capital standards based on whether a banking organization crosses the $50 billion asset threshold. Other provisions of Title I of the Dodd-Frank Act also use the $50 billion asset threshold as an important metric of the potential threat to financial stability that a financial institution might pose.

Our member banks support the principle that the amount of capital required should be reflective of an institution's risk. Applying the proposed capital rules to mid-size banks and the largest banks alike could cause significant disruption to the banking industry, undermine the competitiveness of mid-sized banks, and slow the growth of jobs and the overall economy.

III. Negative Consequences for the Housing Market and the Economy

Under the capital rules as currently proposed, certain residential mortgage products will no longer be profitable unless the interest rate charged to the customer increases dramatically to cover the higher capital and compliance costs. The expected end result is that many consumers will either have to pay more, do without, or go to the unregulated nonbank sector. The MBCA urges the agencies to adopt capital requirements that will permit mid-size banks to continue to serve these customers.

The ability to offer prudently underwritten, nontraditional mortgage products is one of the ways in which mid-size and smaller banks set themselves

apart. These products include interest-only loans, low or no-documentation loans, and junior liens. Unlike large banks, MBCA members continued to underwrite these loans prudently before, during, and after the financial crisis. As a result, many MBCA members have interest-only and low or no-documentation loan portfolios that are performing as well or better than their amortizing loan portfolios. Mid-size banks will be placed at a competitive disadvantage if these products receive the less favorable Category 2 risk weight treatment simply because they do not meet the Category 1 definition, which includes only the most traditional mortgage products.

Moreover, in many cases, the proposed capital rules will penalize a bank that refinances or restructures a customer's loan by requiring the bank to assign a higher risk weight to the new loan. This capital treatment would severely hamper efforts to aid qualified borrowers who have been hit by the decline in home values by discouraging banks from offering the opportunity to refinance or restructure loans. The proposed rules also will penalize banks for retaining mortgage servicing rights by requiring certain reductions from Tier 1 common equity capital and assessing a capital charge against these assets. Mid-size banks are particularly interested in retaining mortgage servicing rights because they value long-term relationships with their customers. This capital treatment discourages banks from aligning their interests with those of their customers.

When coupled with the other provisions affecting mortgages – including Qualified Residential Mortgages, restrictions on capital treatment for mortgage servicing assets, an increase in risk weighting for mortgage loans, implementation of complex rules resulting in an increase in capital required for securitizations – regulated lenders will likely focus only on loans they can sell or securitize with or to Fannie Mae or Freddie Mac. This will only accelerate the concentration of mortgage credit in these institutions and further hinder the resolution of their conservatorship status.

The proposed capital rules would impose a capital charge on unused lines of credit with a term under one year, unless they are unconditionally cancellable. This would lead to uncertainty for small businesses. When the economy shows signs of trouble, banks may cancel a line of credit even though the financial condition of the business borrower remains strong. As a result, small business owners will have a more difficult time planning, hiring, and running their businesses.

The MBCA urges the agencies to take these potential consequences into account when developing simplified capital rules for mid-size and community banks.

IV. Capital Levels of Banks

Finally, the MBCA is very concerned that capital levels will become more volatile under the proposed rules due to the impact of market-value

changes in available-for-sale investment securities. Generally, most analysts expect that an increase in lending will accompany an economic recovery, along with an increase in interest rates. However, under the proposed capital rules, the effect of any increase in interest rates will be a reduction in capital, potentially restricting credit and hampering any economic recovery. We believe the existing rules for determining impairment are sufficient for determining whether an adjustment to income, and thus capital, is necessary and that the proposed capital treatment of AOCI introduces volatility into the capital level of banks unrelated to credit.

V. Recommendations

We believe that it is important that rules implementing Basel III do not create an unlevel playing field, aggravate economic volatility, or limit consumers' access to banking services. We ask that the agencies consider these and other consequences in finalizing any rules applicable to mid-size banks.

Yours truly,



cc: Mr. Jack Barnes, People's United Bank
Mr. Greg Becker, Silicon Valley Bank
Mr. Daryl Byrd, IBERIABANK
Mr. Carl Chaney, Hancock Bank
Mr. William Cooper, TCF Financial Corp.
Mr. Raymond Davis, Umpqua Bank
Mr. Vincent J. Delie, Jr., F.N.B. Corporation
Mr. Dick Evans, Frost National Bank
Mr. Mitch Feiger, MB Financial, Inc.
Mr. Philip Flynn, Associated Bank
Mr. Paul Greig, FirstMerit Corp.
Mr. John Hairston, Hancock Bank
Mr. Robert Harrison, First Hawaiian Bank
Mr. Peter Ho, Bank of Hawaii
Mr. Gerard Host, Trustmark Corp.
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M B C A

MID-SIZE BANK COALITION OF AMERICA

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Banco Popular North America
Bank of Hawaii
BOK Financial
City National Bank
Commerce Bancshares, Inc.
East West Bank
FirstBank Holding Company
First Hawaiian Bank
First Horizon National Corporation
FirstMerit Corporation
Frost National Bank
Fulton Financial Corporation
Hancock Bank
Iberia Bank
MB Financial
Old National
One West Bank
People's United Bank
Raymond James Bank
Scottrade Bank
Silicon Valley Bank
Susquehanna Bank
TCF Financial Corporation
The Private Bank
Trustmark Corporation
UMB Financial Corporation
Umpqua Bank
Valley National Bank
Webster Bank

October 22, 2012

Office of the Comptroller of the Currency
250 E Street, S.W., Mail Stop 2-3
Washington, DC 20219
Docket IDs OCC–2012–0008, –009

Jennifer J. Johnson
Secretary, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
Docket Nos. R–1430, R–1442; RIN No. 7100–AD87

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429
FDIC RIN 3064–AD95

Re: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action; Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements

Ladies and Gentlemen:

On behalf of the Midsize Bank Coalition of America ("MBCA"), I am writing to provide the MBCA's comments on the above-refereneed joint notices of proposed rulemaking published by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (collectively, "the Agencies") in the Federal Register on August 30, 2012.[1]

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[1] *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action*, 77 FR 52791 (Aug. 30, 2012); *Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements*, 77 FR 52887 (Aug. 30, 2012).

The MBCA is a non-partisan financial and economic policy organization comprising the CEOs of mid-size banks doing business in the United States. Founded in 2010, the MBCA, now with 31 members, was formed for the purpose of providing the perspectives of mid-size banks on financial regulatory reform to regulators and legislators. As a group, the MBCA banks do business through more than 3,800 branches in 41 states, Washington D.C. and three U.S. territories. The MBCA's members' combined assets exceed $450 billion (ranging in size from $7 billion to $30 billion) and, together, its members employ approximately 77,000 people. Member institutions hold nearly $336 billion in deposits and total loans of more than $260 billion.

The MBCA appreciates the Agencies' efforts to implement the risk-based and leverage capital requirements agreed to by the Basel Committee on Banking Supervision in "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems," as well as the capital requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[2] We understand that the Agencies devoted extensive time and energy to drafting the proposal rules. However, consistent with FDIC Director Thomas M. Hoenig's request,[3] we respectfully ask you to step back, reassess the overall intent and the impact the proposed rules will have on the financial system, and delay rolling out any new rules.

> In his recent address to the American Banker Regulatory Symposium, Mr. Hoenig summarizes a good capital rule as follows:
>
> Experience suggests that to be useful, a capital rule must be simple, understandable and enforceable. It should reflect the firm's ability to absorb loss in good times *and* in crisis. It should be one that the public and shareholders can understand, that directors can monitor, that management cannot easily game, and that bank supervisor can enforce.

The current proposed rules, which seek to control nearly every aspect of a bank's operations, rely on highly complex modeling tools and on central planners making determinations of risk rather than the markets. As a result, the proposed rules would change risk weights from "five to thousands."[4] Their adoption as proposed would create adverse incentives for banks making asset choices, rather than choices that ensure banks' communities and borrowers are well served. Bankers react to incentives that are placed before them. We believe the proposed rules, if not substantially altered, will potentially skew those incentives and misalign risk and returns. The result will be the loss of some products and services.

At a minimum, the MBCA believes that certain aspects of the proposed rules should be revised to take account of the implementation burdens on banks, their rules' competitive impact on mid-size banks, and the likely consequences of the rules for the availability of credit and

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[2] Pub. L. No. 111-203, 124 Stat. 1376-2223 (2010).

[3] Thomas M. Hoenig, Director, Federal Deposit Insurance Corporation, Address to The American Banker Regulatory Symposium: Back to Basics: A Better Alternative to Basel Capital Rules (Sept. 14, 2012), *available at* http://fdic.gov/news/news/speeches/chairman/spsep1412_2.html.

[4] *Id.*

national financial stability. To streamline our comments, below we address those areas in which we believe revision is most critical.

I. Other Comprehensive Income on Available-for-Sale Securities

The proposed rules would require banks to include unrealized gains and losses on available-for-sale ("AFS") securities currently recorded in accumulated other comprehensive income ("AOCI") as part of common equity tier 1 capital. We believe this approach is misguided for several reasons discussed below.

A. Inconsistent with Sound Asset/Liability Management Practices

AFS investments are critical to a bank's Asset/Liability management practices. In our view, the proposed treatment of these investments would create a disincentive for banks to engage in sound risk management practices. Banks use AFS investments to help stabilize interest income over the business cycle while providing a warehouse of liquidity that can be accessed during periods of high loan demand and/or declining deposit balances. AFS investments serve as a source of liquidity that helps manage the interest rate risk exposure created by core banking activities. Most of a bank's longer-term securities are funded with core deposits that the bank believes have similar or longer durations. If rates rise, the decrease in the value of AFS securities would be offset by an increase in the value of the deposits used to fund the securities. Generally, smaller banks try to minimize taking credit risk in the portfolio by maintaining significant investments in U.S. government and agency debt obligations, U.S. GSE debt obligations, and municipal bonds. This is a sound interest rate risk management practice.

Banks perform interest rate risk management analyses on a regular basis and make hedging decisions based on the performance of the entire balance sheet as rates change. The proposed rules' treatment of AOCI on AFS securities, however, looks at only one piece of one side of the balance sheet. As the AOCI on a bank's AFS investments would be included in regulatory capital under the proposed rules, interest rate changes could have significant implications for regulatory capital. The resulting fluctuations could influence a bank's on balance sheet hedging strategy – economically sound decisions could be compromised if management were forced to modify decisions it believed to be in the best interest of the bank in order to limit mark-to-market implications from one piece of its balance sheet.[5] This could create a capital constraint that may limit otherwise sound Asset/Liability management.

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[5] For example, banks might respond by shortening the duration of their securities portfolios in an effort to reduce volatility. This would result in significantly reduced earnings and would be contrary to sound risk management practices regarding interest rate risk. In a broader sense, if most banks were to follow this path, lack of demand for longer term securities might push up longer rates, making mortgages and municipals, among other longer borrowings, more expensive. Banks might also choose to shorten the duration of liabilities in order to maintain an appropriate mismatch. Where a bank's funding is mostly long-term, non-contractual funding, this move would require adding more short-term wholesale funding – a move clearly at odds with the proposed liquidity standards (LCR and NSFR). Finally, a bank may elect to move some or most of its securities from AFS to Held-to-Maturity simply to avoid the proposed AFS-AOCI requirements. Not only would this result in much less flexibility, but it also may reduce liquidity.

B. Reduced Confidence from More Volatile Capital Measures

In addition to discouraging sound Asset/Liability management practices, the volatility in regulatory capital ratios that would result from the inclusion of AOCI on AFS securities in common equity tier 1 capital would reduce confidence in the capital measures themselves. Even a bank with very strong capital ratios comprised almost solely of common equity – such as one of the MBCA's member banks, which has a total risk-based capital of 16.6% – could be greatly affected if interest rates were to shift quickly. For example,

- A 2% shift up in rates would reduce the bank's regulatory capital by 240 bps as a result of unrealized securities losses.

- A 4% shift up in rates would reduce the bank's regulatory capital by 570 bps as a result of unrealized securities losses.

Such a shift in interest rates could even push ratios close to regulatory limits.

This volatility is exacerbated by the proposed "limited recognition" of deferred tax assets to 10% of common equity. Unrealized gains and losses, including in AOCI, are tax-adjusted such that deferred tax assets are created when unrealized losses exist, reducing the total net amount of unrealized losses. Today, these tax assets are not limited when calculating regulatory capital. If the tax asset is limited, as proposed, and the limit is exceeded, net unrealized losses will create even greater volatility in capital. We believe that the significant volatility created by this proposal and cap on deferred tax assets will result in less confidence in capital ratios as a barometer of adequacy and as a tool for determining a bank's cushion to contain losses. If the proposed rules are adopted as drafted, investors and others will be reluctant – if not unable –to rely on an institution's capital ratios unless the institution removes all or most of the AFS from its balance sheet.

C. Reduction in Lending Capacity in an Economic Recovery

Finally, the proposed rules' treatment of AOCI on AFS securities would decrease the ability of banks to extend credit, as regulatory capital may decrease substantially as interest rates rise. This structural limit on lending by itself will seriously impede a potential economic recovery. Indeed, the effect will be compounded because banks will need to hold additional capital above regulatory limits to protect against even the *potential* for volatility. Lost regulatory capital and lower lending capacity could even result in a declining rate environment, if credit spreads widen or securities lose value simply due to a lack of buyers. This would accelerate an economic downturn.

The MBCA recommends that the Agencies exclude from common equity tier 1 capital AOCI on certain AFS securities for which the gains and losses are primarily due to interest rate rather than credit and market risk changes (including U.S. government and agency debt obligations, U.S. GSE debt obligations, and municipal bonds) to preserve sound Asset/Liability Management practices and to reduce volatility in capital ratios.

II. Deferred Tax Assets

The MBCA believes the proposed rules' requirements regarding deductions of deferred tax assets ("DTAs") from common equity tier 1 capital fail to reflect practical realities in several key respects.[6]

The 10% and 15% limits on DTAs and the 250% risk weight imposed by the proposed rules are unduly punitive. U.S. generally accepted accounting principles ("GAAP") require that DTAs be reduced by a valuation allowance that is sufficient to reduce the DTAs to the amount that is more likely than not to be realized. Therefore, only DTAs that are more likely than not to be realized stay on the balance sheet of a U.S. banking organization. DTAs subject to the limits arise because taxable income computed under the tax laws is higher than income reported under GAAP. Such DTAs should not be viewed as indicators of future earnings problems that would result in depletion of capital – on the contrary, for MBCA members, DTAs are highly likely to yield tax benefits in the future.

Moreover, the 10% and 15% limits on DTAs would exacerbate the regulatory capital impact of the proposed requirement that AOCI on all AFS securities flow through to common equity tier 1 capital. As discussed above, under the proposed rules, unrealized losses on AFS securities would reduce common equity tier 1 capital. Unrealized losses create DTAs. If the amount of DTAs exceeding the 10% and 15% limits were deducted from common equity tier 1 capital, as proposed, AOCI on AFS securities could reduce common equity tier 1 capital twice: first, directly, and second, through the creation of DTAs exceeding the 10% and 15% limits. One MBCA member has calculated that a 400 basis-point rise in interest rates would further reduce its capital ratios by an entire percentage point because of the proposed limits on DTAs and, as a result, reduce its lending capacity by $1.1 billion. Furthermore, subjecting DTAs resulting from AOCI on AFS securities to the 10% and 15% limits is not consistent with prudent management of assets and liabilities because it fails to recognize that the market value of the bank's liabilities funding the AFS securities would rise at the same time as AOCI on such securities creates DTAs.

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[6] Under the proposed rules, a banking organization would be required to deduct the amount of DTAs that arise from operating losses and tax credit carryforwards, net of any related valuation allowances and certain deferred tax liabilities ("DTLs"). In addition, DTAs arising from temporary differences that a banking organization could not realize through net operating loss carrybacks, net of any related valuation allowances and certain DTLs, would be subject to a 10% limit and a 15% limit. Specifically, if the amount of such DTAs exceeds 10% of a banking organization's common equity tier 1 capital, the banking organization would have to deduct the excess from its common equity tier 1 capital. Two other types of assets – mortgage servicing assets (net of associated DTLs) and significant investments in the capital of unconsolidated financial institutions in the form of common stock – would each be subject to such a 10% limit. If the aggregate amount of these three types of assets, after deductions required by the application of the 10% limit to each of them, exceeds 15% of a banking organization's common equity tier 1 capital, the banking organization would have to further deduct this excess from its common equity tier 1 capital. DTAs subject to the 10% and 15% limits, if not deducted from common equity tier 1 capital as a result of the limits, would be assigned a 250% risk weight.

The proposed rules also are problematic in that they would allow netting of DTAs against deferred tax liabilities ("DTLs") only for those that "relate to taxes levied by the same taxation authority and . . . are eligible for offsetting by that authority." Under U.S. GAAP, a company generally calculates its DTAs and DTLs relating to state income tax in the aggregate by applying a blended state tax rate. Accordingly, banks do not track DTAs and DTLs on a state-by-state basis for financial reporting purposes. Tracking DTAs and DTLs on a state-by-state basis for purposes of the regulatory capital rules would be extremely burdensome. Therefore, the MBCA believes that the regulatory capital rules should allow netting in the aggregate for DTLs and DTAs relating to state income tax in all U.S. states, consistent with U.S. GAAP.

The MBCA also believes the Agencies should clarify that banking organizations will not be required to compute DTAs and DTLs quarterly for regulatory capital purposes. Under U.S. GAAP, companies are required to compute DTAs and DTLs annually, not quarterly. The MBCA believes that quarterly computation of DTAs and DTLs would be unjustifiably burdensome for most banks, and that annual computation, as is consistent with U.S. GAAP, is appropriate.

III. Minority Interest

The proposed rules would limit the amount of minority interest in consolidated subsidiaries that could be included in the regulatory capital of the parent company. Specifically, if a consolidated subsidiary has regulatory capital in excess of the sum of its minimum capital requirement plus the required capital conservation buffer, the minority interest that contributes to the excess would not be includable in the parent company's regulatory capital.

This limitation should not apply to a holding company that conducts substantially all its business activities in its depository institution subsidiary and therefore has limited exposure to losses outside that subsidiary. Many banks find that subordinated debt, which is usually issued to investors unrelated to the parent holding company and thus "total capital minority interest" for purposes of the proposed rules, provides a cost-effective form of capital. Limiting the amount of bank-issued subordinated debt that could be included in the parent holding company's tier 2 capital would nevertheless create a significant disincentive for raising such capital. One MBCA member estimates that the proposed limitation would lead to the exclusion of 35% of its subordinated debt from the regulatory capital of its parent holding company. Furthermore, because the proposed limitation would require deductions from the parent holding company's regulatory capital as outside investments in the subsidiary bank increase the regulatory capital of the bank, it would appear that the holding company is being penalized for increased capital adequacy at the subsidiary bank.

IV. Mortgage Servicing Assets

Under the proposed rules, mortgage servicing assets would be subject to the same 10% and 15% limits as deferred tax assets. In addition, the amount not deducted from capital under the proposed rules would receive a 100% risk weight (and eventually a punitive 250% beginning 2018). A mortgage servicing asset is the right by a bank to service mortgage loans owned by others and in many cases represents servicing the loans originated by the servicing bank and sold to other third parties like Freddie Mac and Fannie Mae. The combination of excluding the assets

that exceed the 10% and 15% limits with the 100% (an eventually 250%) risk weighting could severely impact some banks, perhaps even lowering capital levels below well capitalized status. As a result, banks would be inclined to sell mortgage loans on a servicing-released basis. This would prevent a bank that originates a mortgage loan from maintaining a long-term relationship with the borrower by continuing to service the loan after selling it. It would also deprive the bank of an important source of fee income.

Furthermore, the proposed limits would disproportionately affect banks with a sizable portfolio of mortgage servicing assets that have been retained or acquired in reliance on current regulatory capital rules. These new limits might ultimately lead to further consolidation in the mortgage servicing industry to very large non-bank servicers that are not subjected to the same rules and standards as regulated financial institutions. As a result, bank customers would be relegated to dealing relatively impersonally with a large non-bank entity rather than interacting with the local community bank that knows them well. In sum, the MBCA believes that mortgage servicing assets should not be subject to the 10% and 15% limits, and if any limits are put in place, existing mortgage servicing assets should be grandfathered.

V. Unused Lines of Credit with a Term Under One Year

The proposed rules would require a bank to apply a 20% credit conversion factor to "commitments with an original maturity of one year or less that are not unconditionally cancelable" by the bank. As a result, a bank would need to include 20% of the unused portion of a line of credit with a term under one year in its risk-weighted assets, if the line of credit is extended to a corporate borrower.

The MBCA does not believe that the proposed 20% credit conversion factor for the unused portion of a line of credit extended to small, middle-market, or trade finance companies, with a term under one year, is warranted. The majority of such lines of credit have covenants based on financial ratios, and any material increase in the credit risk of the borrower would likely trigger a violation of a financial covenant, which would prevent the borrower from drawing down the unused portion of the line of credit. According to an academic paper from the University of Chicago Graduate School of Business, in a sample of 11,758 bank lines of credit, 72% had covenants based on financial ratios. When a borrower violates a financial covenant, the bank reduces the total line of credit by about 25 % in the year after the violation, and the unused portion of the line of credit is reduced by almost 50% from the year before the violation to the year after the violation.[7] In addition, a violation of the covenant may trigger an entry to the Allowance for Loan and Lease Losses ("ALLL").

We note that several analyses of exposure at default of lines of credit extended to corporate borrowers, including a 2011 study by Moody's, overstate such exposure because they

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[7] Amir Sufi, *Bank Lines of Credit in Corporate Finance: An Empirical Analysis,* 22-25 (Jun. 2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=723361.

exclude reductions in the drawn amount that occurred before default.[8] Reducing the line of credit and the drawn amount when the borrower's credit risk increases is an important risk-mitigation technique, and analyses that fail to recognize this exaggerate the credit risk associated with lines of credit.

Furthermore, most lines of credit extended to small and middle-market companies are guaranteed by their owners. There is less incentive for the borrower to draw down a line of credit so guaranteed when it is likely to default because such draw-downs would increase the personal liability of the business owner.

The MBCA believes that the proposed 20% credit conversion factor would result in further tightening of credit availability to small, middle-market, and trade finance companies. Given this capital requirement, even if banks were willing to make loan commitments with an original maturity of one year or less to small businesses, they would tend to make such loan commitments unconditionally cancellable, which is not common now. As a result, a small business would face the new risk of losing access to existing lines of credit when the economy shows signs of trouble and credit becomes tight, even where the financial condition of the small business itself does not warrant the cancellation of the loan commitments. This uncertainty over credit availability would make it harder for small business owners to plan, hire, and run their businesses. We urge the Agencies to maintain a 0% credit conversion factor for commitments with an original maturity of one year or less and an amount of $5 million or less that are not unconditionally cancelable.

VI. Treatment of Residential Mortgages

A. Risk-weighting of Residential Mortgages

The MBCA disagrees with the Category 1/Category 2 approach developed by the Agencies in the proposed rules. The proposed definition of Category 1 loans would exclude, among others, any loan that (i) results in an increase of the principal balance, (ii) allows the borrower to defer repayment of principal of the residential mortgage exposure, (iii) results in a balloon payment, or (iv) does not include documented, verified income as a feature of the underwriting process. As a result, the proposed rules give the lowest risk weight only to the most traditional mortgage products without regard to the true risk associated with the loan. The proposed rules would exclude prudently underwritten interest only (IO) loans, prudently underwritten low or no documentation loans, and most junior liens, regardless of the performance of those loans. The MBCA believes the categorical exclusion of certain types of loans without regard to the risk associated with the loan is ill-advised, and we discuss the problems associated with that approach using these three examples below.

An IO mortgage is not an inherently dangerous product; any mortgage underwritten properly is a sound asset. Conversely, any loan underwritten poorly regardless of amortizing

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[8] Janet Yinqing Zhao et al., *Usage and Exposures at Default of Corporate Credit Lines: An Empirical Study*, 8 (Dec. 2011), http://www.moodysanalytics.com/Insight/Quantitative-Research/Default-and-Recovery/Research-Papers.aspx.

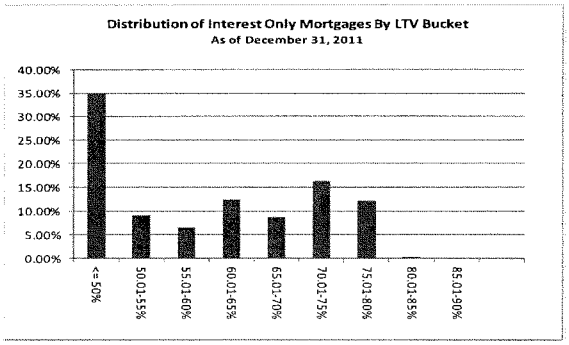
principal features is a risky asset. Many banks have originated IOs for decades and have had very low loss rates even during the recent recession. The IO mortgage transactions of our members historically have experienced very low delinquency rates both in number of accounts and in outstanding balances. One member, the experience of which is typical of MBCA members, noted that the vast majority of its mortgage transactions reside within high-quality credit buckets (LTV <= 60% and FICO scores above 710). Over the last three years, when real estate defaults have peaked nationwide, this member's IO mortgage loans have performed equal to or better than the amortizing portfolio. In other words, this member's IO residential mortgage portfolio is statistically no more risky than the amortizing residential mortgage portfolio. We emphasize the following three key points about the IO loan portfolio:

- Borrowers with low origination LTVs (60% or less) and high FICOs (700+) perform excellently regardless of whether it is an IO or an amortizing loan.

- Our members' stringent underwriting standards, which include qualifying an IO mortgage application based on a fully amortizing debt to income ratio, leads to superior performance of all IO mortgages, even those with LTVs in excess of 60%.

- The Agencies' exclusion of IO mortgages from Category 1 consideration would inadequately represent the true risk involved in a prudently underwritten IO loan. For example, IOs with an origination LTV of 60% have a 12.5 year principal reducing "head start" relative to an 80% LTV amortizing 30-year loan. Thus, there is no reason to penalize a preferable LTV IO mortgage relative to a standard amortizing loan. Labeling an 80% LTV amortizing loan less risky than a 60% IO mortgage is not justified and gives banks the wrong signal.

Treating IO loans as Category 2 by definition does not take into account the fact that when prudently underwritten, a bank's IO loan portfolio can perform just as well or better than its amortizing loan portfolio. In the analysis of one of our members, the experience of which is typical of the MBCA, as of December 2011, close to two-thirds of the bank's IO portfolio exhibited substantial equity in the borrower's home (where LTV is measured as current loan balance to original appraisal value). As indicated in the chart below, approximately 63% of the IO portfolio of this bank exhibited LTVs of 60% or better – over one-third (35%) had LTV's less than 50% or better.



Moreover, a comparison of the same bank's IO loan default rate to its amortizing loan default rate indicates a weighted average probability of default difference of only 1 basis point on a portfolio-wide basis.

Average Default Rates by LTV Bucket

2009-2011 Average	<= 50%	50.01-55%	55.01-60%	60.01-65%	65.01-70%	70.01-75%	75.01-80%	80.01-85%	85.01-90%	A.O.C	Grand Total
IO	0.33%	0.30%	0.64%	0.59%	1.27%	0.97%	0.59%	0.00%	0.00%	0.00%	0.57%
Amortizing	0.33%	0.77%	0.64%	1.27%	0.58%	0.87%	0.38%	13.89%	0.00%	1.85%	0.58%
Difference	**0.00%**	**-0.47%**	**0.00%**	**-0.69%**	**0.69%**	**0.10%**	**0.20%**	**-13.89%**	**0.00%**	**-1.85%**	**-0.01%**

2009-2011 Average Default By FICO Bucket

FICO RANGE	Interest Only	Amortizing	Difference
A) >=830	0.00%	0.00%	**0.00%**
B) 800-829	0.03%	0.00%	**0.03%**
C) 770-799	0.08%	0.02%	**0.05%**
D) 740-769	0.04%	0.02%	**0.02%**
E) 710-739	0.01%	0.01%	**0.01%**
F) 680-709	0.03%	0.03%	**-0.01%**
G) 650-679	0.05%	0.02%	**0.03%**
H) 620-649	0.05%	0.05%	**0.00%**
I) 590-619	0.19%	0.06%	**0.12%**
J) 560-589	0.03%	0.06%	**-0.03%**
K) <560	0.07%	0.28%	**-0.22%**
L) NO FICO	0.01%	0.03%	**-0.02%**
Grand Total	**0.57%**	**0.58%**	**-0.01%**

These data indicate that there is very little statistical difference in credit risk between the two portfolios, and that the proposed rules' approach in categorically excluding IO loans from the lowest risk-weighting is flawed. That a credit product is non-traditional does not in itself make it a higher risk asset; it is the creditworthiness of the consumer that is using the product that must be evaluated to determine the risk. A "disciplined consumer" should be allowed flexibility in choosing a credit product that fits their financial needs. Penalizing banks for using alternative credit products will only cause overall credit to become less available and more expensive.

The disconnect between the risk of a loan and the loan's treatment under the proposed rules also exists for low and no documentation loans. These loans will largely be ineligible for Category 1 treatment as the proposed rules permit a bank to determine a borrower's ability to repay only through "documented, verified income." Income is no doubt an important facet of a borrower's ability to repay and thus the risk of default. In the experience of our members, however, a high down payment (and thus a low LTV) coupled with a high FICO score is an even better indicator of that ability. This is because a high down payment and high FICO score are two hallmarks of a responsible borrower, and because a borrower who is no longer able to pay can more easily sell their house and pay back their loan if the loan has a low LTV.

By assigning higher risk-weights to low or no documentation loans without verified income, the proposed rules will force banks to restrict lending to only the long-term employee with a steady paycheck reflected on a W-2, in addition to improperly risk-weighting existing

bank assets. The groups of creditworthy and deserving people negatively affected by the Category 1 requirements are diverse and numerous: small business owners, retired workers, the self-employed, workers with seasonal or short term jobs, casual union workers (such as long shore workers), independent contractors, and workers who are new in their job or who want to move their family to a new city to take a better job. The approach of the Agencies in the proposed rules is particularly unfortunate given the results of the FDIC's recently released National Survey of Unbanked and Underbanked Households, which urged banks to expand access to the credit system for those not currently served by the banking system.

The definitional exclusion of junior-lien mortgages from Category 1 treatment (except in the case in which no other party holds an intervening lien and the junior lien fully complies with the Category 1 requirements) similarly fails to take into account the true risk associated with a given loan. In reality, the risks associated with a junior lien vary greatly based on the amount of equity the borrower holds in the home and their ability to pay. We believe the risk characteristics of the relationship should be the driving factor in classifying a loan rather than the structure of the loan.

The MBCA urges the Agencies to eliminate the distinction between Category 1 and 2 loans and to tailor the risk-weighting of residential mortgage loans based on the underwriting standards used to make the loans. The Agencies should treat as prudently underwritten (and thus eligible for a low risk weight) loans that a bank extends only after determining the borrower's ability to repay as judged by (1) the borrower's documented, verified income, or (2) a low LTV ratio and high FICO score.

In the event the Agencies keep the Category 1/Category 2 framework, the Agencies should broaden the definition of Category 1 loans to encompass prudently underwritten loans, rather than only the most traditional loans.

B. Coordination with the CFPB Qualified Mortgage Provisions

The Consumer Financial Protection Bureau is evaluating industry comments concerning the definition of a Qualified Mortgage ("QM"). The final definition is critical for the industry because it will represent the standard for residential lending and afford a legal safe harbor for lenders. The consensus in the industry is that the QM definition should be as broad as possible to avoid restricting the availability of credit. One key factor in the qualification as a QM is the determination by the lender that the borrower has the ability to pay the mortgage. Regardless of the ultimate risk weight treatment of residential mortgage loans under the capital rules, and given the broad impact of the QM designation and its clear link to risk, we urge the Agencies to coordinate the underwriting standards included in the proposed capital rules with the final QM definition.

C. Exemption for Loan Modifications

If a mortgage is restructured or modified, the proposed rules require a bank to classify the mortgage in accordance with the terms and characteristics of the exposure after the modification or restructuring. Lenders are allowed to assign a lower risk weight provided they update the LTV ratio at the time of the modification, but are also required to assign a high risk weight if

necessary. If the rules are finalized in their current form, this provision provides a powerful disincentive to banks which might otherwise modify or restructure loans, but will not do so where they would be forced to hold the loan at a higher risk-weight. Loans modified or restructured solely pursuant to the Home Affordable Mortgage Program ("HAMP"), however, are not considered modified or restructured for purposes of this section. The exemption encourages banks to modify and restructure loans, as banks are not required to revisit the risk-weighting treatment of the loan (even though, once modified, the loan has a higher LTV ratio). We urge the Agencies to broaden this exemption from re-categorization of loans to include private modifications and restructurings not completed under HAMP.

D. Grandfathering Existing Loans

The MBCA believes the Agencies should grandfather residential mortgages which were originated under the existing capital rules. Although banks can adjust their lending practices to accommodate the treatment of residential mortgages going forward to avoid some of the more punitive risk weights, they cannot do so with respect to loans already made. To penalize banks now for long-term decisions made under a previous regulatory regime would work a substantial injustice far into the future. Moreover, many banks might not have the data needed to classify existing loans and may find such data difficult, if not impossible, to obtain. Even where they can find the data, bank staff would be required to undergo the extremely burdensome process of going through decades-old loan files to obtain the information.

The substantial increase in the capital that would be required for these loans, which may constitute a substantial amount of assets on an institution's balance sheet, and the retroactive impact of the proposed treatment would be especially harsh. Given that the proposed capital rules already substantially increase the required minimum capital, the need for retroactive application of the new standards is significantly attenuated. In addition, to the extent that loans originated under existing regulations and capital rules truly do reflect more risk to a bank that holds those loans, additional capital should already exist on those portfolios through the ALLL. Providing additional capital for those loans on top of what is already in the ALLL would be a mistake in our view. We believe any final rule should grandfather all existing mortgage exposures by assigning them risk weights as required under the current general risk-based capital requirements (*i.e.*, 50% risk weight).

VII. Treatment of High Volatility Commercial Real Estate

The proposed capital rules would assign a high risk weight of 150% to exposures defined as High Volatility Commercial Real Estate ("HVCRE"). Any credit facility that finances or has financed the acquisition, development, or construction of a commercial real estate project will be defined as HVCRE unless, among other things,

> (ii) The borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15 % of the real estate's appraised "as completed" value.

We believe the choice of using "as completed" versus "project cost" or "stabilized value" adds unnecessary uncertainty to this definition. While the proposed language may be

technically correct, it fails to address tenant improvements, leasing commissions and interest expense after completion. As a result, as drafted, this provision in the proposed rules would require a higher percentage of cash to total cost than 15%, which we do not believe was the Agencies' intent. Separately, the Agencies have failed to provide a definition of the term "readily marketable assets." Below we provide four scenarios in which this language will create problems.

First, our members have clients who have owned their land for many years, in one case dating back to the 18th century, and carried it at zero cost on a GAAP basis. When the land is provided free and clear of liens as collateral to a loan, along with potential other cash equity depending upon the loan structure and appraised valuation, the resulting LTV is well below the maximum supervisory loan-to-value ratio. However, in these cases there is likely not 15% *cash* equity. Instead there is substantial *appraised* equity which results in a conservative LTV. To accommodate such cases, it is our opinion that this provision should permit the appraised equity to account for the required equity in a project so long as the maximum LTV is below the maximum supervisory value. Long-term holders of land should not be singled out and punished by the equity requirement.

Second, in many cities in California, entitlements to build are very difficult to obtain. Land may be purchased at a very low cost if, among other possible circumstances, the entitlements at the time of purchase only allow a single-family residence to be built on the land. However, if the owner of the land goes through the often lengthy and difficult process of changing the entitlements such that the land can be used in a "highest and best" fashion, significant equity can be created. If, for example, the aforementioned single-family residential lot was later entitled for the construction of a 50-unit apartment building, significant value would have been created, thereby allowing for a conservative construction loan to be made well within the maximum supervisory LTV ratio and well below a bank's policy LTV. However, as in the example above there is likely not 15% *cash* equity. Instead there is substantial *appraised* equity which results in a conservative LTV. Here again, the same rationale for allowing for appraised equity to account for the required equity in a project so long as the maximum loan-to-value is below the maximum supervisory value applies. Those property owners who create value through an entitlement change resulting in a use that is "highest and best" should not be singled out and negatively impacted by this requirement.

Third, the "as completed" value is an opinion of an appraiser. Accordingly that value could very likely differ between two different appraisals of the same asset. This has the potential to create unfairness to different borrowers building similar projects. We believe the 15% cash equity requirement should be calculated against the "project cost" as opposed to the "as completed" value. The definition already requires that the loan not exceed the supervisory maximum LTV, which prevents a bank from making a loan on a project that is infeasible. Real estate investors should not be singled out and potentially negatively impacted by differing opinions of value as potentially created by this requirement.

Fourth, the "as completed" value, again a subjective value arrived at in the appraisal process, could be the same value as the "stabilized" value. This would be the case, for example, where the proposed to-be-built building were pre-leased, for instance on a long term basis to a

single tenant that carries an Investment Grade rating. The signing of a lease to this type of tenant creates significant value and again, as with the prior examples, allowing for a conservative construction loan to be made well within the maximum supervisory loan-to-value ratio, but without necessarily having 15% cash equity to the "as completed" value. For this reason as well, we believe the 15% cash equity requirement should be calculated against the "project cost" as opposed to the "as completed" value. Here again, the definition's requirement that the loan not exceed the maximum supervisory LTV prevents a bank from making a loan on a project that is infeasible. Those property owners who create value through the execution of a lease or leases, should not be singled out and negatively impacted by this requirement.

VIII. Capital Conservation Buffer

The proposed capital rules would mandate a capital conservation buffer to incentivize banks to maintain their common equity tier 1 capital, Tier 1, and total capital ratios above the required minimums. Banking organizations would need to hold capital conservation buffers in order to avoid being subject to limitations on capital distributions and discretionary bonus payments to executive officers.

We believe the capital ratios adjusted for the capital conservation buffer will function as a de facto minimum capital requirement since most institutions need and desire the flexibility to make capital distributions to shareholders and appropriately reward executive management. As the Agencies are well aware, market and supervisory preferences will force banking organizations to hold capital in excess of this de facto minimum, essentially leading to additional "buffers" being maintained in excess of the required "buffers." The result, especially when combined with other provisions creating volatility in capital ratios such as the treatment of AOCI on AFS securities, will be to put banks in an extremely defensive position regarding the holding of capital in excess of regulatory requirements. This may significantly curb the ability of banks to extend credit. The Agencies should consider removing the requirement for a capital conservation buffer, or, at a minimum, carving out an exemption from it for small and mid-sized banks engaged primarily in traditional banking activities.

IX. Transition Periods

A. Treatment of Trust Preferred Securities

The Capital Proposal would phase out trust preferred securities ("TruPS") and other non-qualifying capital instruments issued by depository institution holding companies with total consolidated assets of $15 billion or more ratably over a 3-year period beginning in 2013, with full phase-out occurring on January 1, 2016. In contrast, Basel III suggests phasing out such instruments ratably over a 10-year horizon beginning in 2013, with full phase-out occurring on January 1, 2022.

The MBCA understands that Section 171 the Dodd-Frank Act requires the phase out of such instruments over a 3-year period. However, Section 171 does not require a phase out in the aggressive 25% increments contemplated in the proposed capital rules. Moreover, over the Agencies' proposed phase-out period, foreign institutions of $15 billion or more subject to the Basel III phase-out timeline would be able to include more TruPS in regulatory capital than U.S.

institutions over the 3-year period. In other words, while a foreign institution of $15 billion or more would be permitted to include 90% of its TruPS in Tier 1 in 2013, a similar U.S. BHC or SLHC would be allowed to include only 75%. In year two, the foreign institution would be allowed to include 80%, while the U.S. institution could include only 50%, and so on.

Although U.S. institutions will ultimately be put at a competitive disadvantage during the later Basel III phase-out period, in order to minimize this disadvantage, and to give U.S. institutions additional flexibility to phase out non-qualifying capital instruments in an orderly and less punitive fashion, we suggest the Agencies phase-out non-qualifying capital instruments issued by such institutions in 10% increments in each of 2013 (i.e., 90% includable in Tier 1), 2014 (80% includable in Tier 1) and 2015 (70% includable in Tier 1), with full phase-out occurring in 2016. This phase-out schedule is fully compliant with the Dodd-Frank Act.

B. Competitive Disadvantage with Treatment of Goodwill

Although the proposed rules preserve the existing deduction of goodwill, including goodwill embedded in the valuation of significant investments in unconsolidated financial institutions, the rules differ from Basel III in that these deductions are immediately applicable (*i.e.*, in 2013), whereas Basel III phases in the deduction of goodwill over the period from 2014 through 2018. The Agencies should adopt the Basel III phase-out framework as it pertains to goodwill in order to prevent U.S. institutions from being further disadvantaged relative to their global competitors.

* * *

The MBCA appreciates the opportunity to express our concerns and suggestions on the proposals. We look forward to discussing these matters with you in the future.

Yours Truly,



Russell Goldsmith
Chairman, Midsize Bank Coalition of America
Chairman and CEO, City National Bank

cc: Mr. Jack Barnes, People's United Bank
Mr. Greg Becker, Silicon Valley Bank
Mr. Daryl Byrd, IBERIABANK
Mr. Carl Chaney, Hancock Bank

Mr. William Cooper, TCF Financial Corp.
Mr. Raymond Davis, Umpqua Bank
Mr. Vince Delie, F.N.B Corp.
Mr. Dick Evans, Frost National Bank
Mr. Mitch Feiger, MB Financial, Inc.
Mr. Philip Flynn, Associated Bank
Mr. Paul Greig, FirstMerit Corp.
Mr. John Hairston, Hancock Bank
Mr. Robert Harrison, First Hawaiian Bank
Mr. Peter Ho, Bank of Hawaii
Mr. Gerard Host, Trustmark Corp.
Mr. John Ikard, FirstBank Holding Company
Mr. Bob Jones, Old National
Mr. Bryan Jordan, First Horizon National Corp.
Mr. David Kemper, Commerce Bancshares, Inc.
Mr. Mariner Kemper, UMB Financial Corp.
Mr. Gerald Lipkin, Valley National Bank
Mr. Stanley Lybarger, BOK Financial
Mr. Dominic Ng, East West Bank
Mr. Joseph Otting, One West Bank
Mr. Joe Pope, Scottrade Bank
Mr. Steven Raney, Raymond James Bank
Mr. William Reuter, Susquehanna Bank
Mr. Larry Richman, The PrivateBank
Mr. James Smith, Webster Bank
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November 26, 2012

COMMITTEES:
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
Ranking Member
APPROPRIATIONS
ARMED SERVICES
SPECIAL COMMITTEE ON AGING

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street & Constitution Ave., N.W.
Washington, D.C. 20551

The Honorable Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20551

The Honorable Thomas J. Curry
Comptroller
Department of the Treasury
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

RE: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (RIN 3064-AD95)

Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements (RIN 3064-AD96)

Regulatory Capital Rules: Advanced-Approaches Risk-Based Capital Rule; Market Risk Capital Rule (RIN 3064-AD87)

Dear Chairman Bernanke, Acting Chairman Gruenberg, and Comptroller Curry:

I am writing to comment on the proposed rules implementing the Basel III regulatory capital framework.

As the author of Section 171 (the "Collins Amendment") of the Dodd-Frank Act, I believe strongly that capital requirements must ensure that firms have an adequate capital cushion in difficult economic times, and provide a disincentive to their becoming 'too big to fail.' To achieve this, Section 171 requires that large bank holding companies be subject, at a minimum, to the same capital requirements that small community banks have traditionally faced.

During consideration of the Dodd-Frank Act, I supported modifications to the final language to Section 171 to ensure a smooth transition to increased capital standards. Among these modifications were provisions to delay, for five years, the application of new capital requirements for savings and loan holding companies ("SLHCs"), and for certain foreign-owned

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bank holding companies. See subsections (b)(4)(D) and (E) of Section 171. These modifications were intended to allow these entities the time they need to adjust their balance sheets and capital levels in order to come into compliance with the new capital standards. The proposed rules implement the five year delay provided to foreign-owned bank holding companies by Section 171 (b)(4)(E), but neglect to implement the nearly identical delay for SLHCs provided by Section 171 (b)(4)(E). I do not understand why the proposed rules fail to implement this provision, as required by Congressional intent and the clear language of the statute.

I am hopeful, too, that in crafting final rules, you will give further consideration to the distinctions between banking and insurance, and the implications of those distinctions for capital adequacy. It is, of course, essential that insurers with depository institution holding companies in their corporate structure be adequately capitalized on a consolidated basis. Even so, it was not Congress's intent that federal regulators supplant prudential state-based insurance regulation with a bank-centric capital regime. Instead, consideration should be given to the distinctions between banks and insurance companies, a point which Chairman Bernanke rightly acknowledged in testimony before the House Banking Committee this summer. For example, banks and insurers typically have a different composition of assets and liabilities, since it is fundamental to insurance companies to match assets to liabilities, but this is not characteristic of most banks. I believe it is consistent with my amendment that these distinctions be recognized in the final rules.

I am hopeful you will keep these concerns in mind as you continue to implement the Dodd-Frank Act and the proposed rules referenced above implementing the Basel III regulatory capital framework.

Sincerely,

Susan M Collins

Susan M. Collins
UNITED STATES SENATOR

FDIC
Speeches & Testimony

Back to Basics: A Better Alternative to Basel Capital Rules; Thomas M. Hoenig, Director, Federal Deposit Insurance Corporation, delivered to The American Banker Regulatory Symposium; Washington, D.C.
September 14, 2012

Introduction

I have been involved in central banking and financial supervision my entire career. I understand the importance of having the right market conditions and regulatory framework for an economic system to thrive. And most certainly I know that the foundation of a strong financial system is strong capital. For these reasons I wish to add my perspective on today's discussion regarding Basel III. After reading the entire 1,000-plus page proposal, I would encourage the Basel Committee and the international regulatory community to step back and rethink the Basel capital standards.

It may be helpful here to recall how Basel has evolved. Following the implementation of Basel I, many in economics and finance and many of the world's largest banks wanted a more sophisticated and flexible risk-based capital standard. The U.S. chaired the Basel II Committee then and with others agreed that such change was necessary for the largest firms to remain globally competitive. Basel II and III were also given the task of satisfying various national interests, adding more complexity. As a result, the number of Basel risk weights evolved from five to thousands.

Basel III is intended to be a significant improvement over earlier rules. It does attempt to increase capital, but it does so using highly complex modeling tools that rely on a set of subjective, simplifying assumptions to align a firm's capital and risk profiles. This promises precision far beyond what can be achieved for a system as complex and varied as that of U.S. banking. It relies on central planners' determination of risks, which creates its own adverse incentives for banks making asset choices.

The poor record of Basel I, II and II.5 is that of a system fundamentally flawed. Basel III is a continuation of these efforts, but with more complexity. It also is more prolific since it applies across all banking firms. Directors and managers will have a steep learning curve as they attempt to implement these expanded rules. They will delegate the task of compliance to technical experts, and the most brazen and connected banks with the smartest experts will game the system. In private discussions I find a good deal of uneasiness about Basel III's ability to be more effective than previous Basel efforts; however, there is a sense that we cannot go back. I suggest that we not only can go back, we must. In my remarks to follow, I will set out my views on the role of capital and the flaws of Basel III, and then will suggest a simpler alternative that takes us back to the basics.

Capital, the Safety Net and Markets

Capital is the foundation on which a bank's balance sheet is built. There can be no fortress balance sheet without fortress capital. In a market economy, capital insulates a firm from unexpected shifts in risk and from losses on loans and investments gone bad. A reliable capital measure facilitates the public's and the market's understanding and judgment of the financial condition of a firm and industry. And finally, while essential to the health of a firm, capital has its limits. Even high levels of capital cannot save a firm from bad management or save an industry from the cumulative effects of excessive risk taking.

In judging the role of capital, it is useful to look back at bank capital levels in the U.S before the presence of our modern safety net. Prior to the founding of the Federal Reserve System in 1913 and the Federal Deposit Insurance Corporation in 1933, bank equity levels were primarily market driven. In this period the U.S. banking industry's ratio of tangible equity to assets ranged between 13 and 16 percent, regardless of bank size. Without any internationally dictated standard or any arcane weighting process, markets and the public required what would seem today to be excessively high capital levels.

With the introduction and expansion of the safety net of deposit insurance, central bank loans and ultimately taxpayer support, the market's capital demands changed. While the safety net protects depositors from loss and promotes stability in the system, its secondary effect has been to erode the market's role in disciplining banks. Depositors and other creditors have come to understand that the safety net protects them far more importantly than does bank capital or good management.

It is important to ask where these changes have taken us. One of the most significant results has been that bank supervisors rather than the market have been left the difficult task of determining adequate capital for the industry. Unfortunately this has led to a systematic decline in bank capital levels. Between 1999 and 2007, for example, the industry's tangible equity to tangible asset ratio declined from 5.2 percent to 3.8 percent, and for the 10 largest banking firms it was only 2.8 percent in 2007. More incredible still is the fact that these 10 largest firms' total risk-based capital ratio remained relatively high at around 11 percent, achieved by shrinking assets using ever more favorable risk weights to adjust the regulatory balance sheet.

It is no coincidence that the financial industry in 2008 was unable to withstand the pressures of a declining market nor bear anywhere near the losses that the taxpayer eventually assumed. It turns out that the Basel capital rules protected no one: not the banks, not the public, and certainly not the FDIC that bore the cost of the failures or the taxpayers who funded the bailouts. The complex Basel rules *hurt*, rather than helped the process of measurement and clarity of information.

Basel III introduces a leverage ratio and raises the minimum risk-weighted capital ratios, but it does so using highly arcane formulas, suggesting more insight and accuracy than can possibly be achieved. Where the markets assess, demand and adjust intrinsic risk weights on a daily basis, regulators using Basel look backwards and never catch up. For example, people knew well in advance of the recent financial crisis that the risk on home mortgages had increased during the period between 2005 and 2007, yet no changes were made to the risk weights. Basel III still looks backward as demonstrated by the few changes made regarding the weights assigned to sovereign debt.

Finally, it is noteworthy to observe how much the industry's capital level diverges depending on which Basel measure is reported. For the 10 largest U.S. banking organizations as of the second quarter of 2012, total Tier 1 equity capital was $1.062 trillion. Total adjusted tangible equity capital was $606 billion. In a crisis, which number counts?

Given the questionable performance of past Basel capital standards and the complexities introduced in Basel III, the supervisory authorities need to rethink how capital standards are set. Starting over is difficult when so much has been committed to the current proposal. The FDIC is no different from other U.S. and international regulatory agencies where committed staff has devoted enormous effort to drafting and implementing Basel III. However, starting over offers the best opportunity to produce a better outcome.

An Alternative to Basel

How might we better assess capital adequacy? Experience suggests that to be useful, a capital rule must be simple, understandable and enforceable. It should reflect the firm's ability to absorb loss in good times *and* in crisis. It should be one that the public and shareholders can understand, that directors can monitor, that management cannot easily game, and that bank supervisors can enforce. An effective capital rule should result in a bank having capital that approximates what the market would require without the safety net in place.

The measure that best achieves these goals is what I have been calling the tangible equity to tangible assets ratio. Tangible equity is simply equity without add-ons such as good will, minority interests, deferred taxes or other accounting entries that disappear in a crisis. Tangible assets include all assets less the intangibles. [1]

This tangible capital measure does not remove the complexities from the balance sheet. It does not attempt to differentiate risks among assets. It does not tier the measure into any number of refined levels. There is no governmental ex-ante endorsement of risk assets or capital allocations. Instead, this tangible capital measure is a demanding minimum capital requirement within which management must allocate resources within the overall capital constraint. This simple measure accepts that firms quickly shift their allocation of assets to take advantage of changing risks and rewards. This simpler but fundamentally stronger measure reflects in clear terms the losses that a bank can absorb before it fails and regardless of how risks shift. It provides a consistent and comparable measure across firms.

Since the federal safety net is the current substitute for capital in protecting the depositor, it also is reasonable that the supervisor should expect the same minimum capital as would the market without the safety net. As noted earlier, the equity ratio for the banking industry before the safety net was implemented ran between 13 and 16 percent. Therefore, the starting point for any discussion of an acceptable level of tangible equity for all banking firms should be well above the 3 1/4 percent level now implied by the Basel III proposal.

Finally, under this simpler approach there remains the challenge of more precisely assessing individual institutional risk and judging whether this minimum capital is adequate. That

judgment should be determined through the periodic examination process, which for the largest banks has become deemphasized in favor of stress tests. It is the often ignored Pillar II of the Basel standards.

This is no simple task. However, it is through this process, properly conducted, that supervisors can best assess a financial firm's fundamental operations, liquidity, asset quality and risk controls. Some disregard it perhaps because they claim regulatory capture. My own experience is that commissioned examiners as a rule are highly skilled professionals, able to effectively assess bank risk. If the financial supervisors' record needs improvement, we must hold accountable the leadership of the regulatory agencies. The examination process, effectively conducted, holds the best potential to identify firm-specific risks and adjust capital levels as needed.

Can Simpler be Better?

Some argue that a simple measure with a relatively stronger minimum capital level would reduce liquidity in the market, constrain loan growth and undermine the economy. I offer a different perspective.

First, experience tells us that economies compete best from a position of strength, and a strong economy will always have banks with strong capital and balance sheets. The recent recession and credit crunch were made worse because banks had too little capital as they entered the crisis. They were forced to sell assets and shrink their balance sheets in the absence of a strong capital cushion to absorb losses. The U.S. economy would have been significantly less harmed had the financial industry been holding adequate capital in 2008.

Second, the term "increased liquidity" is often used when the objective is really "increased leverage." In the growth phase of an economic expansion, borrowing is readily available, and firms and individuals easily borrow funds. Some describe this as a liquid market. A more appropriate description is leveraging up. Liquidity is the ability to convert assets to cash without loss. Leverage is expanding the balance sheet using debt. It is therefore often the case that greater balance-sheet leverage results in less balance-sheet liquidity. This is especially true in a crisis.

Third, a reasonable capital level does not inhibit economic growth. It sustains it. For example, a 10 or higher percent tangible capital to tangible asset ratio, depending on exam findings, allows a dollar of capital to support as much as 10 dollars of loans and other assets. Leverage is permitted, and credit is available and supportive of long-term growth. Sustainable growth is enabled. Excessive growth is impeded.

Finally, a simple, understandable and enforceable capital standard when measured consistently, not subject to manipulation, and enforced uniformly across the industry provides for equitable treatment of all firms within the industry, from smallest to largest.

In contrast, the Basel Accord would permit a commercial bank to be judged as "adequately" capitalized having a Tier 1 leverage ratio of 4 percent, which implies an even lower tangible equity ratio, so long as the total risk weighted capital ratio is above 8 percent, and the Tier 1 risk weighted risk capital ratio is above 6 percent, and the common equity Tier I risk weighted capital

ratio is above 4.5 percent. This is more complicated than simple, more confusing than clear and more easily gamed than not.

A Final Observation

In reading the Basel proposal, I am convinced that much of its complexity derives from the complexities and conflicts embedded in the combination of commercial banking and broker/dealer activities. The safety net's enormous subsidy encourages ever-greater risk taking as firms attempt to achieve a higher return on equity than would otherwise accrue from operating the payments system and serving as a financial intermediary. In other words, from what they would earn from commercial banking. The safety net's subsidy facilitates the use of leverage and provides an incentive toward higher risks that are hidden in opaque instruments, in trading activities and in derivatives. It bestows an advantage to subsidized firms not afforded others. Solving this problem requires a fundamental restructuring that separates banking from trading activities. [2]

Now, in the mistaken belief that the subsidy can be neutralized, and that risks and shifting risks can be captured, measured and properly and quickly capitalized using financial models, we get Basel III. It's time we acknowledge that no Basel model can accomplish this objective. Markets move too quickly, and human nature is too dynamic.

Basel III will not improve outcomes for the largest banks since its complexity reduces rather than enhances capital transparency. Basel III will not improve the condition of small- and medium-sized banks. Applying an international capital standard to a community bank is illogical, particularly when models have not supplanted examinations in these banks. To implement Basel III suggests we have solved measurement problems in the global industry that we have not solved. It continues an experiment that has lasted too long.

We would be wise to acknowledge our limits, to simplify the system, to confine the subsidy, and to reduce the taxpayers' exposure to an enormous future liability. It is time for international capital rules to be simple, understandable and enforceable.

I understand where the proposal stands today and how much has been invested in drafting Basel III, but I believe the Committee should agree to delay implementation and revisit the proposal. Absent that, the United States should not implement Basel III, but reject the Basel approach to capital and go back to the basics. By doing so, we can focus on efforts that will create a well-managed, well-capitalized, well-regulated financial system that actually supports economic growth.

[1] The measure of tangible equity and tangible assets used here differs from the GAAP measures, which excludes intangible assets such as goodwill, by also excluding deferred tax assets. Deferred tax assets are excluded because they are not available for paying off creditors when a bank fails, that is, they are "going concern" assets but not "gone concern" assets.
[2] My proposal to limit activities supported by the public safety net by restricting commercial banking organizations to traditional banking activities and limited other intermediation activities

can be found at http://www.fdic.gov/about/learn/board/Restructuring-the-Banking-System-05-24-11.pdf

The views expressed are those of the author and not necessarily those of the FDIC.

November 29, 2012

Testimony of Daniel T. Poston

On behalf of

Fifth Third Bank, as Representative of the Regional Bank Working Group

before the

Subcommittee on Financial Institutions & Consumer Credit
and
Subcommittee on Insurance, Housing and Community Opportunity

of the

Committee on Financial Services
United States House of Representatives

November 29, 2012

Chairman Capito, Ranking Member Maloney, Chairman Biggert, Ranking Member Gutierrez, and members of the subcommittees, my name is Dan Poston and I am the Chief Financial Officer of Fifth Third Bancorp, a regional bank based in Cincinnati, Ohio with retail branches in 12 states including West Virginia and Illinois. We were invited to speak with the Subcommittees on the impact on regional banks like Fifth Third and the banking industry of the proposed Basel III capital requirements as well as the risk-weighting rules proposed in the new Standardized Approach. We appreciate this opportunity.

This testimony supplements the testimony made by Fifth Third on matters common to all banks on behalf of the American Bankers Association. We believe our ABA testimony addressed key substantive aspects of the proposals as they relate to regional banks, which would generally be impacted by the rules in manners similar to other banks of various sizes.

This supplemental testimony focuses on aspects of the proposals and related matters which are special interest and concern to regional banks, particularly those with traditional banking models like Fifth Third. There are few fundamental differences among traditional regional banks, whether large or small, which are specifically related to size. However, over the past several years, Fifth Third has participated in a working group of regional banks that have between $50 billion and approximately $300 billion in assets, formed in response to the differential impact of new rules that have been applied to banking organizations with more than $50 billion. A number of these banks

submitted a joint comment letter on these capital proposals[1], and we have worked with them in preparation for our testimony before the House. We and other members of this group were also active contributors to the comment letter jointly submitted by the ABA and other trade groups.[2]

I. The nature and role of regional banks like Fifth Third

Regional banks like Fifth Third are traditional banking organizations, domestically focused, and serving our local communities by providing traditional banking services—primarily deposits, loans, and trust and asset management services. These banks are not complex, interconnected, or internationally active, and do not have large trading or capital markets businesses.

Most regional banks like Fifth Third are banks between $50 billion and $250 billion in assets, which are not subject to the Advanced Approaches framework that applies to internationally active banks or "core" banks above $250 billion. We would note that three traditional regional banks with characteristics similar to our bank and other regional banks have approximately $300 billion of assets, making them also subject to the Advanced Approaches.

Individual banks of this size play an important role in their communities, but are small in the context of the total U.S. banking system, ranging from approximately 0.5 percent to 2.5 percent of total deposit market share, and with assets that are one-seventh to one-fortieth the size of the largest U.S. banks. While relatively small individually, the regional banks in this size range represent about 20 percent of U.S. deposits collectively and likely a similar share of lending. We have tens of millions[3] of customers, who would be impacted by the proposed rules, particularly the Standardized Approach. Banks in this size range have over 500,000 employees as well in total.

Regional banks of our size tend to be geographically diversified, have traditional banking business models, and tend not to have asset risk concentrations that can produce especially outsized losses during crisis periods. While we all experienced challenges, this group as a whole performed

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[1] Letter jointly submitted by Comerica Bank, Capital One, Huntington National Bank, Keycorp, SunTrust Banks, Fifth Third Bank, and Regions Financial Corp.

[2] Letter jointly submitted by the American Bankers Association, the Securities Industry and Financial Markets Association and the Financial Services Roundtable.

[3] For regional banks between $50 billion and $350 billion in assets, a reasonable aggregate for their total customers might be about 100 million.

relatively well during the recent crisis, did not stand out as presenting unusual risks, and none failed.[4]

In terms of our own capital position, Fifth Third is strongly capitalized and we believe our capital position exceeds all proposed capital requirements, even those that would not come into full effect in 2019. We believe the vast majority of other regional banks in the above size range would also currently exceed such requirements as well. Based upon our evaluation of other banks' published estimates of the impact of the proposed rules, we do not believe that Fifth Third would be disproportionately affected by them, although the rules would have a significant impact on us as they would all banks.

II. Simpler generally applicable rules, appropriate for all banks, small and large, would be fully appropriate for regional banks like Fifth Third

The Basel III Capital NPR and Standardized Approach NPR are proposed to apply to all U.S. banks whether or not they are internationally active. This approach – that there should be a uniform set of common capital rules that apply to all U.S. banks operating domestically – is consistent with the current approach which has applied to such banks for decades. All banks use the same basic definitions for each type of capital, are governed by the same U.S. capital requirements, and, for a given type of risk, each bank is required to hold the same amount of capital for that risk. These factors make it critical that a generally applicable risk attribution system be appropriately designed; be relatively simple and aligned with risk; and be one that all banks can implement.

A regulatory capital system should also be consistent in its attribution of risk and in ensuring that banking institutions have sufficient capital to support their risks. Capital rules that do not apply broadly where risks are similar would inevitably lead to concentration of risks where the rules do not apply. This potential to shift capital and risk applies both across asset classes and across institutions. Additionally, if risk-weightings are not truly correlated with actual risks, risks would shift inappropriately among banks or to and from the banking industry to the "shadow banking" sector that is less regulated and more difficult to regulate.

Any change to the generally applicable rules should represent an appropriate change and an improvement on Basel I, and work for all banks of all sizes. We believe a more risk-sensitive risk-

[4] One regional bank of this size was sufficiently challenged at the peak of the crisis that it found it necessary to undertake a sale to another regional bank, at no cost to the FDIC, industry or taxpayers.

weighting framework would be valuable in the U.S., but if mis-calibrated it could be very damaging. Such a proposal should be consistent with risk, be careful not to over-ascribe risk, and not be overly complex or difficult to implement. We believe the design of previous Standardized approach proposals in the U.S. was much more consistent with these goals.

Banks of all sizes, from the largest banks to community banks, have expressed remarkably consistent concerns with these proposals. They would affect all banks, and the customers of all banks, significantly. They would be very burdensome administratively, largely driven by the sheer complexity of the way the rules operate. As large as the administrative burden would be, however, that burden would pale in comparison to the impact on business activities and customer disruption for any bank to which they applied, as it tried to manage conflicts where there is high attributed risk and much lower actual risk.

The rules were developed in the U.S. to replace Basel I for all domestic banks. However, due perhaps to their complexity, they have been commonly characterized as rules that were designed overseas, for large or internationally active banks, which are being applied to domestic traditional banks. Furthermore, it has been suggested that the proposals are so complex that if applied they should only apply to banks greater than $50 billion, which would include traditional regional banks like Fifth Third.

We do not believe the rules as proposed should be applied to anyone. There is absolutely no reason that the proposed rules would be appropriate for banks of our size (or larger), and only such banks, in the absence of any demonstrated special propensity for taking risks or holding risk concentrations. Traditional regional banks do not have special need for a new or different set of risk-weightings to reveal risk. Banks of our size, as well as the largest banks, already are subject to extensive and detailed scrutiny of our risk, in granular detail, through stress-testing and other processes. By rule, these data reporting, capital planning and stress testing processes are far more strenuous than will ever be required for smaller institutions. In short, institutions that have $50 billion in assets are already subject to very significant regulatory "cliff effects," despite the small size of our institutions relative to the banking sector or economy, and despite our traditional banking focus. We do not see a basis for adding another.

There is no reason to introduce a new generally applicable approach is not generally applicable – and certainly not to have a new approach that operated concurrently with two other approaches, while being very different in its operation from the other approaches . If multiple risk weighting frameworks were created and applied based on size alone, it should first be demonstrated that

institution-specific risk is differentiated based on size alone. We don't believe this is the case, or that traditional regional banks of our size have demonstrated such a propensity to accumulate risks. Historical experience clearly demonstrates that banks of any size may take more or less risk, including in traditional banking businesses such as mortgage or commercial real estate lending. The purpose of risk-weighting assets is to reveal risk concentrations where they are not evident from looking at a bank's balance sheet, and then to require them to be appropriately capitalized. If banks take risks, and hold risks, they should be required to hold similar capital for similar risks. This is fundamental to a safe and sound banking system.

The significant and disruptive effects that would result from the introduction of multiple, concurrently operating, risk weighting frameworks can be understood by considering how each approach works. The current generally applicable approach, Basel I, has a relatively simple risk weighting system. This approach enables banks to evaluate risks, price for them, take the underwriting of a loan and the circumstances of the borrower into account, and determine whether a loan should be made and held on its balance sheet. The Advanced Approaches framework, which applies to larger or internationally active banks, enables such banks to manage risk to their own measurements, and we believe would be much less punitive in its treatment of mortgages and particularly home equity lines of credit.[5] In contrast, the Standardized Approach prescribes risk, in ways that we do not believe are aligned with actual risk, particularly for mortgages and home equities. To implement the Standardized Approach, but only for some banks, would be to single out a certain group of banks for prescriptive and punitive treatment in terms of their lending activities, while other banks would operate under risk weighting frameworks that do not prescribe what types of loans are considered risky. This would create a severe and unjustified competitive disadvantage

[5] It is not clear that the operation of the "Collins Amendment" floor would lead to all U.S. banks having effectively the same risk-weighting constraints on their domestic traditional banking business like mortgage or commercial real estate lending. (Dodd-Frank Act Section 171 (b)(2)). The "Collins Amendment" floor is intended to ensure that Advanced Approaches institutions maintain capital that is at least as high as required under generally applicable rules (i.e., the proposed Standardized Approach). This floor applies at the aggregate balance sheet level, for capital ratios, measured against Prompt Corrective Action minimums (rather than the buffered minimums that would serve as the effective capital minimums for U.S. banks). A large capital markets business could also be the cause of the Advanced Approaches producing the constraining ratio. Data should be collected regarding the impact of each approach on U.S. institutions, in order to ensure that domestic competitive balance is maintained, particularly in critical traditional banking businesses and for compuration of the various minimum capitd requirements. We do not believe that banks under either Approach should be significantly advantaged relative to the other, or that their ability to offer similar products to their customers should be affected, simply due to these different risk-weighting approaches.

for any banks so affected, and would be damaging to those banks' customers who have made the choice to bank with them.[6]

We fully recognize and appreciate that banking regulators understand these issues, which they have articulated and which formed the foundation of their making the proposals generally applicable to all banks.

We certainly sympathize with smaller banks with respect to the burden of these rules and the impact they would have on their activities. We would also experience these burdens. We believe that appropriate and simpler rules should not be, and do not need to be, so burdensome to any bank. Effective rules should build on and reinforce effective risk management practices whose costs institutions are already bearing, which would significantly mitigate the additional burden.

In summary, we fully agree that the rules as proposed are overly complex and should be simplified and aligned with risk so that they can provide a common risk framework that would work for all banks. The rules are not complex because they were designed for, or are especially appropriate for, complex institutions or for traditional regional banks larger than $50 billion. They are complex primarily because they include a risk attribution framework that has never been identified or proposed previously, and the interactive effects of critical aspects of the rules (especially between home equity and mortgage loans).

We believe the appropriate way to address these issues is for the rules to be withdrawn, studied and, if necessary, re-proposed, in a simpler form more directionally and proportionally aligned with risk. Until such rules are identified and applied that would work for all banks, small and large, we believe the current Basel I rules should remain in place for all banks. Traditional regional banks of our size have not shown a higher risk propensity than banks smaller than us, or larger than us. Therefore, a generally applicable replacement for Basel I that works for smaller banks would work just as well for larger banks, including regional banks, for all of the reasons outlined above.

Summary

[6] If both a Standardized Approach and a different generally applicable approach were in place, we believe banks under the Standardized Approach would not be able to demonstrate lower capital requirements using the more risk sensitive approach, even though the risk weights under each approach were assigned by banking regulators. The Collins Amendment floor, as currently written, does not allow a bank's capital requirements to be less than would be computed under the generally applicable approach.

Fifth Third supports a more risk-sensitive system of generally applicable rules, one that works well and applies broadly, that identifies risks where and as they are, and that treats similar risks with similar capital treatment. There are nearly 7,000 banks in the United States, the vast majority of which are community banks. Therefore, any generally applicable approach must start by working for those banks. We believe that such an approach would be entirely appropriate for traditional regional banks and the risks they take as well.

Banks large and small have voiced very strong and remarkably consistent concerns about the operation of the Standardized Approach, its complexity and burdens. They have noted the differences in its risk attribution for mortgage, home equity, and commercial real estate loans – in comparison with Basel I and the Advanced Approaches; in comparison with previous standardized approach proposals; and in comparison with their risk experience. We very much appreciate that the banking agencies have indicated they will carefully consider the industry's observations and concerns.

Lawmakers, banking regulators, and bank employees are all under incredible pressure to implement many changes in the way banks are regulated in the U.S. Careful study to ensure consistent and workable rules for all is absolutely critical. Replacing the generally applicable rules for risk-weights is a complex process, and we believe it requires that regulators and the industry communicate and work together to calibrate risk-sensitive rules appropriately and to have the time to study and align them. This approach would better ensure that resulting impacts to credit flows and economic activities are desirable and appropriate in both direction and scope. For these reasons, we believe that changes to generally applicable risk-weightings should not be required to follow the same time-line as proposed changes in minimum capital requirements, especially given that this Standardized Approach proposal is not required to be implemented under any Basel agreement.

Fifth Third appreciates the opportunity to present our views to the Subcommittees for your consideration.